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TAX EXPENDITURE BUDGET AND RELATED POLICIES

TASK FORCE ON TAX POLICY AND TAX EXPENDITURES

OF THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

MARCH 8, 1976

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TAX EXPENDITURE BUDGET AND RELATED POLICIES

MONDAY, MARCH 8, 1976

U.S. SENATE,
TASK FORCE ON TAX POLICY AND
TAX EXPENDITURES,
COMMITTEE ON THE BUDGET.
Washington, D.C.

The task force met, pursuant to notice, at 10:07 a.m., in room 357, Russell Senate Office Building, Hon. Walter F. Mondale (chairman of the task force) presiding.

Present: Senator Mondale.

Staff members present: Bert Carp, task force coordinator; Ira Tannenbaum, tax counsel; Ted Haggart, minority staff member.

Senator MONDALE. The meeting will come to order.

Senator Moss asked that a statement by him be placed in the record. It will be.

OPENING STATEMENT OF SENATOR MONDALE

REVENUE TARGET

Senator MONDALE. In preparing the revenue target in the first concurrent budget resolution for fiscal year 1977, the Budget Committee must consider three key questions.

The first is the amount of revenue to be expected under current law.

The second is whether additional tax cuts are needed to spur economic recovery.

The third is the amount of revenue gain or loss to be expected in the next year from legislation modifying the tax expenditure budget and related tax policies. This third question—the subject of today's hearing—is especially important to the budget for fiscal year 1977, in view of the probability that a major tax bill will pass the Congress this year.

TAX REFORM ACT

The House of Representatives—which under the Constitution must act first on revenue legislation—last December sent to the Senate H.R. 10612, the "Tax Reform Act."

That bill contains structural provisions which would increase revenues in fiscal year 1977 by $3.3 billion, accompanied by provisions which would reduce fiscal year 1977 revenues by $1.7 billion. The net revenue gain from the House-passed bill would be $1.6 billion.

However, it is important to note that the House bill would make a number of crucial provisions effective retroactively, as of last January 1. If these provisions were made effective next January, the revenue gain in the coming fiscal year would be negligible.

TAX CUT RECOMMENDATIONS

In addition, the Senate Finance Committee has completed its budget recommendations, which allocate $20 billion in fiscal year 1977 for net tax cuts below the levels provided in permanent 1974 law. This amount would allow continuation of last year's temporary tax cuts at a cost of $17 billion, and $3 billion in further reductions. Additional tax reductions would be available under this recommendation only if offset by other revenue-gaining action.

We also have before us the President's budget, which proposes a tax cut of $28 billion below 1974 law, and which proposes elimination of only one tax expenditure—the earned income credit designed to bring modest relief to low-income working families with children.

REVENUE TARGET

It is important to bear in mind that the Budget Committee's role in the tax debate this year is a delicate one. Under the Budget Act, we must recommend a revenue target—and to reach that target we must estimate both tax cuts and offsetting tax increases. In our report we must break the revenue target down among sources of revenue—personal income taxes, corporate income taxes, payroll taxes, excise taxes. And over the long term we are responsible for helping the Congress to analyze the relationship of tax expenditures and policies to the direct programs of the budget.

But we are not responsible, in the first concurrent budget resolution for this year, for designing the revenue bill which will come before the Congress within the next 4 months. Designing that bill, within the framework set by the budget resolution, will be the work of the Finance and Ways and Means Committees, and of the Congress as a whole as revenue bills come to the House and Senate floors.

STATEMENT OF SENATOR MOSS

The Congressional Budget and Impoundment Act of 1974 established an improved congressional budget process for determining national spending and revenue policy priorities. Under that act, the Budget Committee must develop and recommend to the Senate a first concurrent budget resolution by April 15. The budget resolution will set Congress' fiscal policy and budget priorities for the coming fiscal year. It will also set targets for spending, revenues, and the budget surplus or deficit which is appropriate in light of economic conditions and other factors.

REVENUE TARGET

The design of the revenue bill is the responsibility of the House Ways and Means Committee and the Senate Finance Committee. The Budget Committee's responsibility is to recommend a revenue target. In order to reach that target, of course, we must estimate both tax cuts and offsetting tax increases. Our report must consider revenues from all the various sources.

In developing a revenue estimate, the committee must consider three things: Revenue estimates under current law; revenues resulting from proposed tax law changes, in macroeconomic terms; and revenues (increases and decreases) resulting from structural changes in law.

In focusing on the third item, the committee's consideration must include: (1) What changes in law are expected to be enacted that would affect revenues in this time period? and (2) what would be their effect on revenues?

Such a determination will be influenced by the outcome of the following:

—H.R. 10162, the "Tax Reform Act" passed by the House last December and sent it to the Senate. That bill contains structural provisions which would increase some revenues and reduce others for a net revenue gain of $1.6 billion. The House bill is under consideration by the Senate Finance Committee.

—The President's budget which proposes a tax cut of $28 billion below 1974 law, and proposes elimination of the earned income credit—a tax expenditure—designed to bring relief to low income working families with children.

To assist us in reaching a better understanding as to what we can expect in revenues, we have the Senate Finance Committee's report to the Budget Committee in accordance with the Budget Act. The Finance Committee's recommendations include allocation of $20 billion in fiscal year 1977 for net tax cuts below the levels provided in the permanent law—1974. This amount assumes continuation of last year's temporary tax cut at a cost of $17 billion and an additional $3 billion reduction. Under this recommendation, the additional tax reductions would be available only if offset by other actions which produce revenues.

From a revenue viewpoint, the tax legislation which ultimately passes Congress is important not only in terms of the structural changes but the timing—the effective date of the changes—as well.

The first level estimates of budget revenues and expenditures—used by the administration and the Congress—have traditionally excluded the "ripple effects" through the economy. Is this realistic? Should such estimates be made more comprehensive?

TAX EXPENDITURES

The Budget Control Act also requires that, beginning with the fiscal 1977 budget, tax expenditures be considered at each step of the new congressional budget process. This requirement stems from a recognition that numerous provisions of Federal tax law confer benefits on some individuals and institutions that are comparable to direct Federal spending, but that these tax law benefits seldom are reviewed, in comparison with direct spending programs.

The concept of tax expenditures is a relatively new one which is still in the process of being refined, both with respect to the provisions classified as tax expenditures and the methods of calculating the revenue losses stemming from such provisions. Nevertheless, failure to take tax expenditures—which now aggregate about $100 billion in Federal funds—into account in the budget process now would be to overlook significant segments of Federal policy.

Tax expenditures are instruments of public policy and generally can be viewed as alternatives to other fiscal actions such as direct outlays and credit programs. In fact, many such programs operate in the same areas as expenditures from the Federal budget. Consequently, the

Budget Act wisely requires that they now be included in the budget—the central document dealing with Government resource allocation. Almost all tax expenditures serve either to encourage particular economic activities (e.g., business investment, personal investment, spending by State and local governments and support of charities), or to reduce the taxes of persons considered to be in adverse circumstances (e.g., those with large medical expenses).

Thus, tax expenditures are not only important from an economic or budgetary viewpoint, but they carry significant social considerations which must not be overlooked.

I am pleased to join Chairman Mondale in welcoming today's witnesses and look forward to receiving their views on this important subject which is of significance to the outcome of the budget process.

Senator MONDALE. We look forward to hearing from today's witnesses. Our first witness, representing the National Association for Manufacturers, will be Mr. C. Raymond Cahoon, accompanied by Dr. Norman Ture and Mr. Cliff Massa.

PANEL CONSISTING OF C. RAYMOND CAHOON, TAX LEGISLATIVE ADVISER, MOBIL OIL CORP. AND CHAIRMAN, TAX IMPACT PROJECT TASK FORCE, NATIONAL ASSOCIATION OF MANUFACTURERS; ACCOMPANIED BY NORMAN B. TURE, PRESIDENT, NORMAN B. TURE, INC., ECONOMIC CONSULTANT, NAM; AND CLIFF MASSA III, DIRECTOR OF TAXATION, NAM

STATEMENT OF C. RAYMOND CAHOON

Mr. CAHOON. As you stated, I am C. Raymond Cahoon, and I might add, Senator, I have had the pleasure of appearing before you before this in connection with your capacity as chairman of the Senate Finance Committee's Subcommittee on State Taxation of Interstate Commerce.

Senator MONDALE. Where we made marvelous progress.

Mr. CAHOON. Maybe we will do better with this one.

As you stated, on my right is Mr. Massa of the NAM and Dr. Ture who is a consultant here in Washington and who we have now just taken on to work with us on this project that I am about to talk about.

CAPITAL FORMATION

In this regard we are interested in the Finance Committee's report on a bill containing provisions of capital formation which we understand and I think you just stated shows so-called revenue losses of $3 billion. This brings me to the subject which is of particular concern to the NAM which we believe your task force should very seriously consider: Is the traditional revenue estimate an adequate measure of the impact of tax proposals in the capital formation area or of any other tax proposals for that matter?

In discussing your invitation to testify with your staff we noted our interest in discussing questions in this area, namely what type of economic impact analysis should be taken with respect to tax proposals, are traditional forms of revenue impact sufficient or are they even

reliable indications of the effects of tax changes. It was suggested that this was certainly an area which should be explored and we were invited to begin that exploration with you today. Our presentation will therefore be limited to this general area.

TRADITIONAL REVENUE ESTIMATES

In brief, our view is that the traditional revenue estimate is inadequate at best and completely misleading at the worst. This discussion will indicate why we hold this view and what we are trying to do to stimulate public discussion in this area. This subject is of significance to the budget process, and therefore to this task force, as well as to the tax legislative process, because revenue estimates must be developed in assessing how tax legislation will affect expected Federal receipts, the budget deficit (or surplus) and national fiscal policy.

Up until the creation of the new congressional budget process—including the budget committees and the Congressional Budget Office—the only congressional interest in questions about the effects of tax changes on total Federal revenues was found in the two tax-writing committees. The Senate Finance Committee and the House Ways and Means Committees historically have prepared and reported bills with detailed estimates as to the revenue "gains and losses" which various provisions would cause. These estimates very often are used to support or oppose particular policy positions, depending on what the estimates say.

TAX CHANGES OCCUR IN A VACUUM

The procedure used to arrive at such revenue estimates is based on the assumption that tax changes occur in a vacuum and that taxpayer's behavior will not be altered in response to those changes. By making that assumption, the estimator is then able to calculate how the tax change will affect anticipated tax revenues, according to the levels of income expected in the coming years. This can be called an initial impact revenue estimate. To briefly illustrate, assuming an expected $100 billion in taxable corporate income, a 10 percentage point reduction in the corporate rate would be estimated to result in a $10 billion revenue loss, but have no effect on the level of taxable income, currently or in the future.

This initial impact figure is the type of estimate which traditionally has been prepared and discussed by the Staff of the Joint Committee on Internal Revenue Taxation, working for the congressional tax committees, and by the Treasury Department.

At this point I should emphasize that the concerns which we have do not reflect on the excellent quality of work performed by the Joint Committee Staff or by the Treasury, but rather with the limitations which the basic procedure itself imposes on the analysis provided. As to the procedure, it has the advantage of being relatively simple to calculate and difficult to dispute as to its mathematical accuracy. It has been used with tax legislation for decades. In recent years, its use has spread to the annual listing of tax expenditures and how much they cost in terms of foregone tax revenues.

Beginning with your trial run of the budget process for fiscal 1976 and now continuing into your first required use of that process, the revenue estimate takes on yet another responsibility. It is being used

in determining what tax legislation can be enacted to raise or lower anticipated revenues to the level fixed by the budget process. The foremost example to date was last year's Ways and Means Committee's consideration of the DISC provisions. One of the principal arguments for full repeal was to pick up the $1 billion in revenue required by the conference committee resolution. Used in this fashion, the initial impact revenue estimates are about to become an even more significant national economic policy mechanism.

INITIAL IMPACT REVENUE ESTIMATES

The NAM believes that the initial impact revenue estimates are inadequate and has undertaken a special effort, which will be described later, to develop more comprehensive approaches to analyzing tax changes. Because the congressional budget structure is new and is not tied to one way of doing things, we encourage you also to take a critical look at the traditional revenue estimate to determine how reliable and useful it is.

Senator MONDALE. I might interrupt there to say we have counsel who does exactly that, our chief economist Arnie Packer.

Mr. CAHOON. Possibly we could be more helpful to him and work with him.

"FEEDBACK" EFFECTS OF CHANGES IN TAX POLICY

The business community's concern stems from a questioning of the basic assumption underlying the traditional procedure—namely, that tax changes take place in a vacuum and that taxpayers do not react to tax changes. We simply do not believe that it is reasonable to assume that tax policy does not affect economic activity in significant ways beyond the tax liability of separate taxpayers. We believe that it affects investment, employment and output throughout the economy, and these feedback effects of changes in tax policy can override the assumed revenue impact, resulting quite possibly in a totally opposite effect.

We strongly believe that a broader type of analysis should accompany tax legislation, analysis which indicates the nature and the magnitude of the effects on various segments of the economy. These effects should be taken into account in developing net revenue impact numbers—that is, initial impact offset by the feedback—which would be of more use to you in the Congress than inital impact numbers, particularly in assessing the long-term desirability of proposed changes. Certainly, there will be differences of opinion as to what secondary or feedback effects will follow a change and as to how to estimate them at different stages of the business cycle.

TAX EXPENDITURES

Senator MONDALE. The whole idea of the so-called tax expenditure approach is to do just what you argue should be done—take a look at each preference and ask, "What do we buy for it?"—just as we are required in this law to take a look at each appropriation, say, "Is this beneficial, can we afford it, how effective is it?" In effect we

are asked to appropriations and so-called tax expenditures in the same pot for purposes of the evaluating process.

Mr. CAHOON. We are certainly agreeing with the desirability of doing that and we are kind of floundering around to try to find a good way with the computer expertise that we all have today to do this very thing. I guess we have more or less come to agreement that there certainly will be differences of opinion as to what those effects are, but again I emphasize that there should be no question about the fact that this really should be done. Here are the reasons really:

TAX STRUCTURE

During the past 60 years, the individual rate structure has grown to a minimum of 14 percent and a maximum of 70 percent on unearned income, approximately 12 times the comparable 1913 rates. The maximum rate is now 48 percent on corporate income, making the Federal Government virtually the equivalent of a 50 percent preferred shareholder in this country's largest business enterprises. Obviously, the existing Federal income tax giant now plays a very significant role in the functioning of our economy.

Businesses and individuals alike make their investment and spending plans on the basis of many factors. Too often overlooked is that taxes enter into these decisions not only by affecting spendable income but also by changing the costs of alternative courses of action.

We believe that the existing tax structure is strongly biased against savings and investing and toward consumption, and the results of this bias are reflected in the economy's low rates of capital formation and productivity increases. Changes in the tax laws to reduce this antisaving, anti-investment bias would result in greater increases in capital outlays and in the stock of capital than the economy would otherwise achieve. These greater increases have not only a direct impact in expanding output, jobs, and incomes, they also have a longer-lasting effect in increasing the amount of capital with which employees work. This, in turn, increases their productivity, the number of jobs, and real wage rates. As business and individual income rise, the Federal Government's tax base also expands. The initial revenue loss from the tax change, as traditionally estimated, diminishes and turns into a revenue gain.

The initial impact estimates do not take account of any of these expansionary responses to tax changes which reduce the antisaving and investing bias; instead they assume that nothing happens. Using my first example of a $10 billion corporate tax cut, the traditional revenue estimate says, in effect, that the money simply disappears.

NAM'S TAX IMPACT PROJECT REPORT

Because we feel so strongly about the inadequacies of traditional revenue estimates, the NAM's Committee on Taxation undertook a special project to study the development of other approaches. The first product of our tax impact project task force was the TIP report, the second printing of which is attached to this statement.[1]

[1] See p. 56.

Combining long-term and short-term goals, the TIP report was undertaken with three general objectives in mind. They were:

—To begin the development of a method of estimating the overall economic impact of business-related tax proposals in general.

—To develop economic impact estimates for specific proposals which might arise in 1975, the year of the report's issuance.

—To lay the groundwork for the possible development of a continuing project which could assess very rapidly the economic impact of any major tax proposal.

We recognize that the tax impact project represents only one of a number of possible approaches to the economic analysis of tax proposals. This type of analysis is intended to indicate the direction and the order of magnitude of the impact of the tax changes which were studied, not precise economic forecasts.

To stimulate further such discussion, the NAM is sponsoring a 1-day public conference in Washington on Tuesday, April 20. At least one person from the staff of each member of the congressional Budget and Tax Committees has been invited to attend, along with persons on the committee staffs. We believe that this will be a very informative and enlightening program, and we strongly urge you to be sure that your offices are well represented. Everyone in attendance will be able to take part in questions and discussions with the program speakers.

10-PERCENT INVESTMENT TAX CREDIT

To illustrate the differing results between traditional revenue estimating and the type of economic impact analysis which we are trying to encourage, consider one major provision of the House-passed tax bill, H.R. 10612, which the Finance Committee is likely to adopt—namely, an extension of the 10-percent investment tax credit. The 10-percent credit has been in effect since 1975 and the proposed extension would run through 1980. Initial impact revenue estimates indicate a loss of $3.3 billion in 1977, $3.4 billion in 1978, $3.6 billion in 1979, and $3.7 billion in 1980. On the other hand, the TIP report, table 1 on page 1,[1] shows net revenue losses of $1.8 billion in 1977, $1.6 billion in 1978, $1.4 billion in 1979, $700 million in 1980. In 1981, there would be a revenue pickup of $300 million, which would increase in later years. In addition, it shows a net increase in employment of 340,000 jobs over the same period. All of this based on the very conservative assumption that the full impact of the 1975 increase in the credit would take 18 months to be effective. It is more likely that the net revenue increase and job creation occurs much faster.

AWARENESS OF THE PROBLEMS

We are encouraged by signs of interest in this subject in the Congress, in the executive and in nongovernmental groups. NAM has already testified specifically about TIP to the Senate Select Committee on Small Business. The Manufacturing Chemists Association released a report in 1975 entitled "Taxation and Jobs: An Impact Survey" in which tax changes were studied in terms of their impact

[1] See p. 64.

on investments for expanding employment in that industry. During their 1975 markup of a tax bill, the House Ways and Means Committee looked at DISC in terms of its effects on exports and employment, besides its initial revenue impact. The Senate Finance Committee's report late last year on the tax cut extension included a table showing the estimated impact which the cuts would have on GNP, unemployment, prices and industrial output if extended through 1977. In the special analysis on tax expenditures from the President's budget for fiscal 1977, it is noted that:

> The second major assumption used to make the [tax expenditure] estimates is that taxpayer behavior and general economic conditions remain unchanged in response to the hypothetical change in the tax laws. This assumption is required to estimate tax expenditures but it is, in most cases, unrealistic.—(Special Analyses, Budget of the U.S. Government, Fiscal Year 1977, p. 122.)

From conversations with Treasury officials, we are aware that they are interested in developing more comprehensive techniques for public exposure. Dr. Ture has used this concept in many situations, such as in his economic impact analysis of the various provisions of the Jobs Creation Act sponsored by Rep. Kemp (R-N.Y.) and 100 other House members.

CONCLUSION

Tax policy is economic policy and, as such, its overall impact should be considered. We do not believe that traditional revenue estimates are either complete or even very informative in this regard. An effort is being made to develop a more comprehensive approach, and we encourage the Congress to take part in this effort.

TAX REFORM AND FEEDBACK EFFECT

Senator MONDALE. Thank you very much.

In compiling the data for your tax impact project, you assumed there was an 18-month interim period between the tax change and the secondary feedback effect.

If the tax reform is made effective during fiscal year 1977, would not the feedback effect be negligible within the fiscal year?

Mr. CAHOON. In doing the project, sir, we deliberately took that very conservative approach. In other words, how long does it take, for a company, in learning of the change and knowing that it is the law, to make their planning and gear up for the change. Of course, that varies terribly among companies. We feel we are going very much on the conservative side by picking the 18 months.

Senator MONDALE. But it would be the effect if the tax reform was made effective in fiscal year 1977, feedback effects in fiscal year 1977 would be negligible?

Dr. TURE. I think not, sir. I would have to agree with Mr. Cahoon that the TIP project assumption of an 18-month response period was excessively long. It was done in the interest of taking a very conservative estimating approach, but all the indications I know of suggest a much quicker response on the part of the business community. I think you ought to look for very substantial effects within 1 year after enactment on the assumption that your proposal is something that people can count on.

Mr. Cahoon. That is the important thing, sir. As you know, there has been much criticism of the off-again-on-again effects of the investment credit. I certainly concur with what Dr. Ture just said.

EFFECTS DIFFER WITH TAX CHANGES

Senator Mondale. If it is valid to include in the budget the secondary effects of the tax change, is it not also valid to include the secondary effects in the changes of Government expenditures? When the budget includes transfer payments to be made to individuals, should we not seek to assess the effects such payments would have on individual aggregate consumption, savings, national income and employment?

Dr. Ture. Senator, if, in fact, there is an effective way of estimating those effects, they certainly should be included. The problem is there are wide disagreements among people who try to make such estimates as to what is likely to happen and the effects will wander all over the place.

Senator Mondale. Aren't they identical problems?

Dr. Ture. Conceptually they are very much the same thing, but it doesn't necessarily follow the results are the same. There are a lot of econometric analyses that show that the effects of an increase in Government expenditures on total demand and total income are very, very short lived, something like a quarter or two quarters, and then it is offset by an equal negative effect so that something like over a fiscal year's time the effects wash out to a zero.

I personally will not attest to the validity of those analyses. I was not involved in their preparation. But the results don't seem to me from a theoretical point of view to be particularly unlikely. There are quite different effects associated with tax changes. Those are effects that deal with changes in the relative prices of alternative courses of action. They may involve very, very substantial shifts in the allocation of resources which may have much, much longer-lasting effects, hopefully so.

FOREIGN VERSUS DOMESTIC INVESTMENTS

Senator Mondale. In calculating the secondary effects of changes in the tax laws relating to foreign-source income, you have assumed that a corporation's domestic income varies directly in proportion to its foreign income. Is not this assumption open to question in light of recent studies such as those by Professor Musgrave that suggest that foreign investment is undertaken as an alternative to domestic investment?

Mr. Massa. Senator, we recognize that the assumptions that were made with respect to the foreign-source income changes were considerably open to question. The TIP report's assumption that any changes in foreign versus domestic investments as a result of tax policy changes would be the same is subject to question. However, this is not so much on the basis of the studies which Professor Musgrave has done, because as I recall in the last study which she submitted to the Senate Foreign Relations Committees she states, either in the summary or the report itself, that it is just an assumption that

foreign investment takes place at the expense of domestic investment and if foreign investment were not available or open that domestic investment would necessarily be increased.

We do recognize that our assumption is open to question and therefore the foreign-source income provisions of the TIP report are a little less reliable. However, we think that it is important to begin in the foreign source income area also to try to develop some way for estimating what the impact of tax changes would be. We think it is more important to recognize the concept of needing to do this type of analysis in the foreign area than to swear by the particular numbers that are here.

BUSINESS AND PERSONAL TAX CUTS

Senator MONDALE. Does the NAM believe that there should be business and personal tax cuts beyond the extension of the 1975 temporary cuts if this would cause an increase in the President's $43-billion deficit target?

Mr. MASSA. Our problem, Senator, with answering that question directly is whether or not we believe that the tax cuts are going to result in a large increase in the budget deficit.

As we have been discussing this morning, particularly with major tax cuts that would affect individuals' elections to save versus consume and the corporate community's ability to make investments, we think that a number of major tax reforms which we support, both in the individual and corporate area, even if they had an initial revenue impact in the first year, would be worth the small increase in the deficits, because the long term impact is going to be to increase the Federal revenue base and also to increase the economy's ability to put its resources and its labor force to work.

So I suppose we have to get down to particular proposals which we are not prepared to do this morning.

As a general statement, we don't think tax reductions should be foregone simply because the initial impact revenue estimates would say that you are going to add five or ten billion dollars to the deficit because we strongly question the validity of those estimates.

SPENDING LID

Senator MONDALE. Does that put the NAM in the big-spender category?

Mr. CAHOON. I was going to add, Senator, that is not to say that we don't concur in the effort to put a lid on spending. We think that both can be done but we think that realistically——

Senator MONDALE. Take it out of something else, right?

Mr. CAHOON. Looking at the spending realistically, you have to have a good focus on exactly what the revenue pact is.

Senator MONDALE. Do you have an opinion about which tax preferences—investment credits, corporate rate cuts, personal tax cuts, would be most effective in stimulating recovery or do you recommend a mixed approach at this time?

Mr. CAHOON. That goes to NAM policy so I will go to Dr. Ture or Mr. Massa to answer that.

EXTEND TAX REDUCTIONS

Mr. MASSA. The recommendations which we are going to make to the Senate Finance Committee in the testimony later this month center on tax reductions and tax reforms affecting the business community principally, because that is our constituency. We will recommend a number of items, principally the extension of reductions which have already been made, namely the small business tax provisions, like the corporate surtax exemption, and an extension of the 10-percent investment tax credit, partly and, in fact, largely because of the facts which Mr. Cahoon has mentioned, that is the desirability of having that type of provision permanent if it is going to be fully useful.

AREAS OF IRC THAT NEED REFORM

We do think it is necessary to go beyond those provisions because there are a number of other areas of the Internal Revenue Code affecting business income which need reform.

One of them is the capital recovery allowance area, the whole concept of recovering invested capital. Others are pollution control expenditures, and a general rate reduction.

In the individual area, we think that reforms which would affect individuals' decisions on consumption versus savings are going to be important. Without endorsing any concepts, I know Dr. Ture is interested in reforms affecting individuals in terms of a tax credit for their net increases in savings during the year. I know Senator Long is considerably interested in the ESOP concept, so we are not limiting ourselves to saying that the specific proposals we will make will be sufficient and will undo all of our problems.

A general change in tax policy as it affects investments and savings is desirable. As I understand it, not being a trained economist, but I think Dr. Ture might comment on this, to the extent that you can increase the economy's overall savings, it may not make so much difference whether the particular tax cut affects the corporate rate or the investment tax credit or a person's individual savings or whatever.

So a number of changes could take place that would be helpful to the economy over the long term.

Mr. CAHOON. Dr. Ture has a rather intriguing suggestion, although we have not planned on talking about it. If you would bear with him for a few minutes, I think it is something you would be interested in.

Dr. TURE. Thank you.

INCREASE SPENDING OVER LONG RUN

Let me preface that description by responding to your question directly as to the immediacy of the focus of tax changes. To be sure, we are all concerned about extending and strengthening the recovery which the economy is now experiencing. There is a hazard that we focus exclusively on that and ignore what our long-run concerns are. The problems are not unrelated. One can argue, but I think that virtually everyone will agree about this, that if in fact we can undertake tax changes which have the effect of getting anybody in the economy to increase spending, no matter for what, that is likely to have an expansionary effect on GNP, employment and real incomes.

The question is what kinds of spending do we want to have increased at this point in terms of long-run considerations. For the longer run what we are all, I think, most concerned with is making sure that we can at least maintain the postwar trend rate of increase in productivity, employment, and in real wage rates. In order to be able to assure that, with all of the demands that are going to be imposed on the business community for capital formation, it becomes extremely important to make sure that there are the real resources available to finance those capital additions which go directly into increasing the productivity of the worker.

EDUCATION INVESTMENTS

Senator MONDALE. Does that include appropriations to educate people better?

Dr. TURE. The kind of expenditure that is relevant is that which will expand the total capital in the economy, tangible and nontangible, human and nonhuman. The addition of a modest amount of education that an increase in the appropriations can make I think is probably very slight in contrast with very substantial increases in productivity that are associated with increasing physical plants.

Senator MONDALE. Aren't there any number of economic studies showing that our wealth today is heavily the result of our investments in education?

Let's take the energy problem. Think of the impact we can have if we develop new sources of energy. I just read the other day where somebody developed a light bulb that might have a revolutionary impact on energy consumption, and I assume that he went to school somewhere and I assume the public paid for his education or most of it and for the research that went into his discovery. When we look at the need for investment capital don't we also have to bear in mind the need for appropriate investment in human technological development?

CONTINUED INCREASE IN CAPITAL OUTLAYS

Dr. TURE. Certainly, sir. I doubt that Dr. Dennison will attribute the capacity of the gentleman who discovered this new light bulb to the public educational process. I think that is a much more highly specialized kind of education that comes in on-the-job training, which is a kind of investment, indeed, in human capital and not to be neglected, it seems to me, is a tax policy which assures that the business community will continue to increase its capital outlays sufficiently to maintain rising capital-labor ratios.

INCREASE TOTAL SAVING RATE

As Mr. Cahoon and Mr. Massa indicated, there is no one specific tax change that is guaranteed to do that or is superior in doing that rather than any other. The big problem is to increase the total saving rate in this country. That can be achieved in dozens of ways, one of which I would commend to your attention. This has been a long way around to get to what Mr. Cahoon suggested I tell you about.

This is a proposal to provide a tax credit for individuals who increase their savings during the course of a year, increase the net

amount of their saving; in order to assure that it would not be merely a tax advantage for upper-income individuals, the proposal calls for a cap on the amount of the credit, not to exceed $1,000 on a single return or $2,000 on a joint return. The credit would be available at 10 percent of the amount of the increase in such savings.

If you look at the Internal Revenue Service's statistics of income, you find, interestingly enough, that a very, very substantial part of the returns on savings were reported on those income tax returns and, therefore, indicating the substantial part of savings was undertaken by individuals, with adjusted gross incomes of $20,000 or less.

It seems to me that a proposal of this sort would not be subject to the charge that it was directed to fat cats or upper income individuals but would be available for taxpayers generally. I think that the favorable consequences of this in terms of the response of individuals to increase their savings, reduce the cost of capital, increase the rates of capital formation, and, in time, and not a very long time either, to increase the rates of productivity advance and real wage rates would be substantial.

Senator MONDALE. Thank you very much.

TYPES OF SAVINGS

Mr. CAHOON. If I could, sir, I might ask Dr. Ture to just add one more comment as to the types of savings we are talking about, because it is a broad spectrum and possibly if you would round it out by just exactly what type of saving and investments we are talking about?

Dr. TURE. I would suggest virtually all of the standard forms of saving of the ordinary householder with the possible exception of the increase of the equity in his residence for which he has fairly substantial favorable tax treatment. It would include investments in common stocks and government bonds and insurance policies and so forth.

TAX CREDIT FOR COLLEGE EDUCATION SAVINGS

Senator MONDALE. Would you broaden that to give a tax credit for parents sending their kids on to college?

Dr. TURE. That proposal has been around for a long time, and I think it deserves much more thoughtful consideration than it has generally received. I think it is a very provocative and very useful kind of proposal.

Mr. CAHOON. I think it is inherent in this credit that it would go to that sort of thing, take a fellow with a savings account in a bank, if you will, as long as he is increasing the basic amount in that savings bank, albeit putting money aside for the children for college or anything else, he would be getting this credit so it certainly would enhance the opportunities of the average individual, if you will, to put away money for school.

Dr. TURE. We ought to go a step beyond that in that investment in education is treated in a very perverse way under the existing tax law and it is difficult for me to understand what the principle underlying that treatment is. That is a very valuable investment. It is becoming an increasingly costly kind of investment. There is no deduction allowed for the investment, the saving that has to go into it at the time the investment is made and the individual in whom the invest-

ment has been made gets no offset against his taxable income when he starts reaping the returns on it. It is one of the cases in which the bias against saving and investment is most flagrant, presumably to serve some objective or social policy purposes that I do not understand at all. I do indeed agree with you, something very seriously ought to be down about this.

Senator MONDALE. Thank you very much.

Our next witness is Mr. Arnold Cantor, assistant director of research, AFL–CIO, and we will have a panel which also includes United Auto Workers represented by Howard Young, special consultant to President Woodcock; and the Council on National Priorities and Resources, represented by Joan Bannon, assistant director and by Carl Bade, secretary, United Church Board for Homeland Ministries.

PANEL CONSISTING OF ARNOLD CANTOR, ASSISTANT DIRECTOR OF RESEARCH, AFL–CIO; ACCOMPANIED BY RAY DENNISON, LEGISLATIVE DEPARTMENT; HOWARD YOUNG; SPECIAL CONSULTANT TO THE PRESIDENT, UNITED AUTO WORKERS; JOAN BANNON, ASSISTANT DIRECTOR, COUNCIL ON NATIONAL PRIORITIES AND RESOURCES; AND CARL A. BADE, SECRETARY, UNITED CHURCH BOARD FOR HOMELAND MINISTRIES

Senator Mondale. If it is all right, let's begin in the order that you were called with Mr. Cantor first.

Mr. CANTOR. Thank you, Senator.

STATEMENT OF ARNOLD CANTOR

I am Arnold Cantor, assistant director, Department of Research, AFL-CIO. I am accompanied on my far right by Ray Dennison of the legislative department of the AFL-CIO.

It is a pleasure to have this opportunity to present the AFL–CIO's views on the tax policy questions involved in the development of the congressional budget for the fiscal year beginning October 1, 1976.

TAX REFORM GOALS

We feel that this task force can make a substantial contribution to both the budgetmaking process and the need for tax justice by focusing attention on the importance of tax reform and its many goals:

—A means to raise Federal revenue;
—A means to promote fairness;
—A means to strengthen the Federal Government's ability to provide essential public facilities and services; and
—A means to make tax policy a more effective tool for resolving the Nation's economic problems.

TAX STRUCTURE LOOPHOLES

The huge demands placed on the tax structure as a result of the economic crisis which began in 1973 provide a current illustration of the needs. The emergency tax cut enacted in March 1975 was a major

factor in cushioning the economic downslide and enabling the economy to survie the near disaster of last winter. Yet, at the same time, if the loopholes of special privilege to wealthy individuals and corporations were not so wide and fewer dollars escaped tax structure, more money would have been available to bolster consumer purchasing power and fund the programs necessary to create jobs, protect the jobless, and help State and local governments provide essential factlities and services.

This task force has before it the administration's list of "tax expenditure" which details billions upon billions of dollars that the Treasury does not collect because of special exclusions, exemptions, preferential rates and the like.

This list includes many items which we view as appropriate to a tax structure that is to reflect ability to pay and help forward economic and social goals. This list also includes many—but not all—of the most glaring loopholes in the tax code. The administration's list does not, for example, consider as a "tax expenditure" the estimated $7 billion in annual revenue lost through the exclusion from income taxation of capital gains transferred at death. Nor does it include the two provisions—deferral and the foreign tax credit—which subsidize the overseas activities of U.S. multinational corporations at the expense of American jobs and technological progress and cost some $8 billion in lost revenue.

Nevertheless the tax expenditure list does provide a vivid and provocative added dimision to the significance of the tax structure and the vast potential that exists for change and improvement.

TAX JUSTICE STATEMENT

We would like to submit for the record a copy of the policy statement on tax justice adopted by the AFL–CIO Executive Council at its February 1976 meeting. That statement spells out the major proposals which could raise as much as $20 billion in Federal revenue. Although we recognize that the Budget Committee does not have the responsibility to develop a specific program of tax justice or recommend specific tax reform legislation, we feel that our proposals can provide guidance to the committee in its efforts to target major areas of consideration.

In view of this body's specific task of focusing on tax policy in terms of the congressional budget for the forthcoming fiscal year, we urge concentration on major areas and provisions which are costly in terms of dollars lost and at the same time, through their elimination, could strengthen the economy and help put an end to the recession.

TAX SUBSIDIES—U.S. OVERSEAS CORPORATIONS

In that light, we would like to call attention to the tax subsidies for the overseas operations of U.S.-based multinational corporations. The AFL–CIO believes Congress should place top priority on eliminating these preferences which have eroded the tax structure, destroyed American jobs, and spurred the outflow of U.S. capital, technology, and knowhow.

Specifically, we call for:

1. An end to the foreign tax credit provision which allows U.S. corporations to credit foreign income taxes on a dollar-for-dollar basis against their U.S. tax liability. In our view, taxes paid by U.S. corporations to foreign governments should be treated as costs of doing business just like the taxes U.S. corporations pay to State and local governments.

2. An end to the deferral privilege which allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home—which may be never.

3. Elimination of the Domestic International Sales Corporation—DISC—which allows corporations to spinoff into export subsidiaries in order to defer, perhaps indefinitely, 50 percent of the taxes on export profits.

These three tax subsidies cost the United States more than $9 billion in annual revenue.

H.R. 10612—TAX REFORM ACT

In addition, we also recommend that the Budget Committee consider the Tax Reform Act—H.R. 10612—passed by the House in December. The modest reforms contained in that bill would raise about $1.5 billion in revenue in the fiscal year beginning October 1, 1976. By merely strengthening some of the provisions such as those applying to tax shelters, and the minimum tax and completely eliminating the Domestic International Sales Corporation—DISC—gimmick the revenue raised by the House-passed bill could be tripled.

TAX JUSTICE PROPOSALS

The above proposals are, we believe, modest in terms of revenue to be gained. There are other proposals in the AFL–CIO's tax justice program, which would raise many billions of dollars more in revenues. For example:

—Elimination of the across-the-board depreciation speedup. This loophole will cost the Treasury and the American taxpayer $1.8 billion in fiscal 1977;

—An end to the capital gains loophole. The preferential half-tax on unearned income from stocks or other property sold at a profit and the zero tax when these gains are passed on at death will cost the Treasury $8 billion to $10 billion in fiscal 1977; and

—Overhauling Federal estate and gift taxes. An effective and equitable estate and gift tax structure could generate several billion in additional annual revenue.

Finally, we call upon the Budget Committee to recognize that its major task is to prepare a congressional budget that can help put America back to work as quickly as possible. We, therefore, urge that this task force state clearly that its revenue-raising recommendations for fiscal year 1977 are offered as a means to help finance essential job- and income-generating Federal programs.

[The statement by the AFL–CIO Executive Council on tax justice follows:]

STATEMENT BY THE AFL–CIO EXECUTIVE COUNCIL ON TAX JUSTICE

Despite years of rhetoric, campaign promises and some small improvements recently adopted by Congress, the federal tax structure continues to be riddled with injustices.

Recent government reports have presented some dramatic illustrations:

—In 1973, according to the Internal Revenue Service, 22 individuals reporting incomes of $500,000 and over paid no federal income taxes whatsoever—seven of these super wealthy Americans reported that their income in 1973 was over $1 million.

—Eight large corporations with profits totaling $844 million paid no income taxes in 1974, according to a congressional study. The effective average corporate tax rate for 142 of the nation's largest companies was only 22.6 percent—less than half the statutory 48 percent rate.

—U.S. Treasury data shows that U.S.-based multinational corporations earned $53.6 billion abroad in 1974 and paid U.S. corporate taxes of $1.7 billion—an effective tax rate of only 3.2 percent.

As a result of these and other injustices, working families pay much more than their fair share of the tax load.

In 1969, a small step was taken toward eliminating and curbing some of the major tax loopholes, despite the Nixon Administration's attempts at sabotage.

But by 1971 those small steps were completely reversed under the Nixon Administration tax giveaways to business.

Early last year, as part of the emergency tax cut to stimulate the economy, some additional small steps toward tax justice were taken. The oil depletion allowance was substantially eliminated and limitations were put on some of the loopholes available to U.S.-based multinational corporations.

The emergency tax cut and its extension to mid-1976 prevented a further downward spiraling of the economy and made a modest contribution to tax justice. In light of continued high unemployment and the need for consumer purchasing power, the tax cut cannot be allowed to lapse in June.

The Administration has now proposed an array of new tax giveaways designed to benefit corporations, bank and wealthy individuals. The Administration forecasts a huge 32 percent increase in corporate profits for 1977 and admits its tax giveaways would save corporations $12.2 billion in taxes in 1977 alone.

In the 1960s, corporations paid about one-third of the nation's income taxes. In recent years, the corporate share has slipped to about 25 percent. By 1981 the Administration wants the corporate share of the nation's income tax load to be cut to less than 20 percent.

Obviously, that would mean the workers' share of the tax burden would increase even more.

The President's proposal of a so-called $28 billion income tax cut, linked to an equal slash in the budget, is pure politics. There would not be a $28 billion tax cut, in fact, and it is an excuse to dismantle vitally needed social programs.

We call upon the Congress to reject the President's political gimmick.

We urge the Congress to extend the present payroll tax withholding rates now scheduled to expire.

America's workers and the American economy cannot tolerate an increase in taxes this summer.

Further, the AFL–CIO urges rejection of across-the-board "tax incentives" for business investment—including further depreciation speed-ups, permanent investment credits, dividend write-offs, proposals to widen even further the capital gains loophole and additional gimmicks for the wealthy.

The Administration's scare talk of impending shortages of capital for all private business investment is unfounded. There may be some special and unique problems that will require specific tax incentives for a particular industry. In those clearly documented cases where the need has been amply proven, the AFL–CIO has already demonstrated its willingness to support measures tailor-made to meet the problem.

We will continue to oppose across-the-board tax gimmicks which would shift more of the tax burden to the backs of average Americans.

TAX JUSTICE PROPOSALS

As the Congress reviews its work on tax justice, we further urge:

(1) Top priority to eliminating tax subsidies for the overseas operations of U.S.-based multinational corporations. These preferences have eroded the tax structure, destroyed American jobs, spurred the outflow of U.S. capital, technology, and know-how. Specifically, we call for:

—An end to the foreign tax credit provision. The present practice of allowing dollar-for-dollar credits against a multinational company's U.S. income tax liability must be ended.

—An end to the deferral privilege which allows multinational corporations to defer U.S. income tax payments on the earnings of their foreign subsidiaries until such profits are brought home—which may be never.

—Elimination of the Domestic International Sales Corporation (DISC) which allows corporations to spin off into export subsidiaries in order to defer, perhaps indefinitely, 50 percent of the taxes on export profits.

Ending these foreign tax subsidiaries would raise some $9 billion in annual revenue.

(2) Elimination of the across-the-board depreciation speed-up enacted in 1971. This loophole currently costs the Treasury and the American taxpayer over $1.5 billion annually. The $8 billion-a-year investment credit, enacted as a one-shot stimulus for a sagging economy, should be ended as soon as the economy returns to high levels of production and employment.

(3) An end to the capital gains loophole. The preferential half-tax on unearned income from stocks or other property sold at a profit and the zero tax when these gains are passed on at death costs the Treasury $8–10 billion in annual revenue.

(4) An end to the tax exemption for interest income from state and local bonds. Such income should be taxed in full, with the federal government providing an interest subsidy to assure that fiscal powers of the state and local governments are not hampered. Such a measure would broaden the market for municipal bonds, help financially pressed state and local governments as well as end a loophole which benefits only banks and the very wealthy.

(5) Limitation of the corporate surtax exemption to small corporations. Under current law, the first $50,000 of a corporation's taxable income is taxed at less than one-half the 48 percent corporate rate. Such an exemption is justifiable only if restricted to small corporations. It should be denied to wealthy corporations.

(6) End tax shelters, such as mineral exploration and oil drilling ventures, real estate, hobby farms and the like, which benefit only the wealthy. Revenue losses from these schemes total over $1 billion annually.

(7) Strengthening the provision requiring a minimum tax payment from the wealthy who would otherwise pay little or no tax.

(8) Overhauling federal estate and gift taxes. Present law provides loopholes to minimize or postpone tax payments for generations, through devices such as family foundations and generation-skipping trusts. An effective and equitable estate and gift tax structure could generate about $3 billion in additional annual revenue.

Senator MONDALE. Our next witness is Howard Young.

STATEMENT OF HOWARD YOUNG

Mr. YOUNG. Yes, sir. I appreciate this opportunity to testify on certain tax aspects of the budget. The chairman's letter describing today's hearing stated that it was to focus on issues other than the personal tax cut—which, under the Revenue Adjustment Act of 1975, is due to expire as of June 30, 1976. Thus, I will concentrate on the question of additional revenue which should be generated through tax reform.

TAX SYSTEM EQUITY

The UAW's primary goal with respect to that question is achieving increased equity in the tax system. Under present tax law, lower and middle income people bear a taxload which is disproportionate to their ability to pay. Although the Federal tax system looks progressive on paper, the myriad of loopholes available to special groups and special interests make a mockery of that apparent progressivity. Furthermore, the structure of State and local taxes usually aggravates the inequities. The share of taxes paid by corporations has been steadily reduced due to erosion of the tax base by subsidies and incentives. That approach is all the more objectionable when it is recognized that administering such subsidies and incentives through the tax system is usually an ineffective—or at least inefficient—way of achieving their intended purposes; the investment tax credit is an outstanding example of that, it simply does not stimulate sufficient additional investment to justify its continuation.

TAX REFORM OVERDUE

It is my understanding that the Budget Committee's function is not to deal with the specific changes that ought to be made in the tax code, but rather to concentrate on the budgetary effects of those changes. Nevertheless, we urge the committee to endorse the concept that needed revenues be raised through tax reform, as such action is overdue. Expiration, on June 30, of the current temporary tax provisions provides the need for the third major tax action by this Congress. When the Tax Reduction Act of 1975 was under consideration early last year, the UAW agreed with many others that the situation was sufficiently urgent as to justify postpoining action on tax reform in order to effect a speedy tax cut. Once that was done, we pointed out—for example, in Leonard Woodcock's testimony before the House Ways and Means Committee last July—that action on tax reform was due; unfortunately, the Revenue Adjustment Act of 1975 did not achieve that; even H.R. 10612 which passed the House but then was sidetracked, did not include sufficient reforms. The Congress should not pass up another opportunity to act on tax reform; the American people deserve a more equitable tax system.

ABOLISH INVESTMENT TAX CREDIT

In his testimony last July, Leonard Woodcock proposed specific reforms which would have produced about $10 billion additional revenue in 1976. While we have not updated our estimates, it is certain that those same reforms would yield a higher amount in 1977. Furthermore, our estimates last July did not include the effect of the 10-percent investment tax credit—as compared with the prior 7-percent level—since we were doing 1976 figures, and that higher tax credit level applies through this year. Thus, in considering the effect on 1977 revenue, allowance should be made at least for reversion of the investment tax credit to the 7-percent level, thus increasing 1977 revenues by about $3.3 billion over 1976 revenues; in fact, we would favor complete abolition of that credit. Similarly, those estimates did not anticipate continuation into 1976 of the $50,000 surtax exemption and the 20-percent

tax rate on the initial $25,000 of taxable income. Those provisions are estimated to reduce revenues by $1.9 billion, if in effect for all of 1976.

TAX EXPENDITURES

Therefore, we urge the Budget Committee to recommend that tax reforms be adopted which will increase calendar year 1977 revenue by approximately $16 billion, as compared with calendar year 1976 revenue which would result from a continuation of the provisions currently in effect.

There are a number of tax expenditures which could be modified in order to produce that additional revenue; in fact, we estimate that comprehensive tax reform would produce over $25 billion. We will provide the tax-writing committees with more detailed proposals, but it may be helpful to list for your committee some such possibilities in addition to the investment tax credit and corporate profits provisions already mentioned:

TAX PROPOSALS

—Closing the capital gains loophole, thus treating earnings from capital the same earnings from labor for purposes of taxation.

—Dismantling of tax shelters such as farming operations, real estate, natural resources, et cetera, which allow the rich to shield and wash out otherwise taxable income. Until these tax shelters are eliminated, the "minimum tax" provisions should be strengthened.

—Eliminating the tax exemption for interest income from State and local bonds, which benefits the banks and the very wealthy. The Federal Government should provide interest subsides so that State and local governments will not face higher costs when they borrow from the public.

—Revising Federal estate and gift taxes. In 1972, there were 93 gross estates of $1 million or more on which no Federal inheritance tax was paid.

—Eliminating the vast net of tax preferences for foreign-earned income which in many cases make corporate investment abroad preferable to investment at home.

—Repeal of the Domestic International Sales Corporation (DISC) gimmick which allows the deferral of taxes on part of the profit of export subsidiaries spun off by U.S. corporations.

—Repeal of the accelerated depreciation provisions which, since 1971, have permitted corporations to defer their taxes by charging depreciation at higher rates than was previously allowed.

ADDITIONAL TAX RELIEF

As indicated at the outset, this statement has dealt with only limited tax issues. The UAW will provide the Budget Committee with its views on the more comprehensive revenue and expenditure matters. However, it is important to make clear that we do not advocate raising additional revenue in order to decrease the projected budget deficit. Rather, we

intend that such funds be used to provide additional tax relief to those with less than $20,000 annual income, and to finance needed Government expenditures beyond those recommended by the President.

We believe that reducing tax expenditures will move us toward the twin goals of a more equitable tax system, and more adequate social programs.

Senator MONDALE. Thank you very much.

Miss Bannon.

STATEMENT OF JOAN BANNON

Miss BANNON. I am Joan Bannon, appearing today on behalf of the Council on National Priorities and Resources.

The Council on National Priorities and Resources is a nonprofit association of organizations representing local governments, business and labor, educators and farmers, religious organizations, and minority groups. The member organizations include the Amalgamated Clothing Workers of America, AFL–CIO; American Federation of State, County and Municipal Employees, AFL–CIO; Americans for Democratic Action; National Education Association; National Farmers Union; Oil, Chemical and Atomic Workers, International Union, AFL–CIO; International Union, United Auto Workers; United Church Board for Homeland Ministries; United Mine Workers of America; United Presbyterian Church, U.S.A.; and the U.S. Conference of Mayors.

The Council on National Priorities and Resources is committed to promoting the use of national resources to meet human needs. We believe that tax expenditures are frequently as important as direct program expenditures in the Federal budget and must be taken into account in discussing national priorities. Although the organizations comprising the council have, in the past, given their primary attention to spending programs, their concern with overall priorities is inevitably leading them into involvement with the modification of tax laws.

TAX INEQUITIES

Fundamental reform of our system of taxation is long overdue. Never before has the loophole-ridden tax system seemed so unjust. Massive tax avoidance by wealthy individuals and corporation is quickly eroding not only the tax base but the confidence of taxpaying citizens in the fairness and integrity of their Government. According to a study by the Treasury Department, nearly one-fourth of all tax subsidies in fiscal year 1974 went to the wealthiest 1.2 percent of taxpayers. The 160,000 richest taxpayers in this country (0.2% of all taxpayers) saved a total of $7.3 billion in taxes in fiscal year 1974, due simply to tax loophools and subsidies. And 14.6 percent of all taxpayers—those with incomes over $20,000—received 53 percent of the benefits from tax breaks.

According to the most recent figures available, in 1973, more than 500 individuals with incomes over $100,000 paid no Federal income taxes whatever.

TAX BREAKS

The reason for the inequity becomes obvious as soon as one looks at the list of tax credits, deferrals, exemptions, and deductions available to the American taxpayer when filling out his tax form. Although available in theory to everyone, in practice only a small number of tax breaks are truly available to those earning moderate incomes of $15,000 or less. Favorable treatment of capital gains, the exemption of income from tax exempt bonds, excess depreciation deductions, and many other tax benefits provide preponderant benefits to the top 1 or 2 percent of the income scale.

Corporation benefit from even more tax breaks and giveaways than wealthy individuals, and as a result, corporations are paying a shrinking share of the total burden of taxes. According to a study by Otto Eckstein, "Profits and Profit Taxes Revised, 1974", the average effective Federal tax rate on corporate profits dropped from 43.3 percent in 1971 to 34.0 percent in the first quarter of 1974—a rate which probably dropped still further in 1975, due to the increase in the investment tax credit and in the corporate surtax exemption.

Give the dramatic and well-known inequities of the tax structure, it is no wonder the American people are beginning to lose faith and confidence in the American political system.

It has been 7 years, since enactment of the Tax Reform Act of 1969, that many major change has been made in the tax structure. Yet, in the economic crisis gripping this country during the last 2 years, unique and critical demands have begun to make themselves felt on the Nation's budget. For revenues to meet these increased demands, they must continue to grow, but this necessary growth will be severely curtailed unless and until gross tax injustices are eliminated and the wealthy are required to pay their fair share of taxes.

TAX EXPENDITURES

Tax deductions and other tax subsidies are often called tax expenditures. Money lost to the Treasury through various subsidies and loopholes is really no different from money collected through the tax code and then spent through the budget. In each case the money represents a kind of transfer between the Government and certain beneficiaries.

It is noteworthy that since 1968, the tax expenditure budget has been growing just as fast or faster than the national debt, GNP, budget outlays, or total revenues. In 1968, tax expenditures resulted in a revenue loss of $44.14 billion; in 1977 the value of tax expenditures will have risen by an astronomical rate of 97 percent to $86.9 billion. Moreover, the Congressional Budget Office in its 5-year projections predicts the tax expenditure budget will rise to approximately $150 billion by 1981.

Obviously, tax expenditures have become an increasingly important part of the Federal budget. Yet, pointing to the way in which tax expenditures have grown, the inequities they produce, and the manner in which they have quietly eroded the tax base, is not to say that all tax expenditures are inherently bad. There are many tax provisions

designed to help taxpayers meet certain basic needs, such as emergency medical care and housing, or to induce economic activity considered by everyone to be vital to the Nation.

ELIMINATE SUBSIDIES THAT SERVE NO PUBLIC PURPOSE

It is those subsidies that serve no public purpose at all which should be eliminated. What our decisionmakers need are reasonable criteria against which expenditures may be ranked and judged. We must look at each subsidy in terms of the legitimacy of its goals, and whether it is meeting those goals, in terms of whom it benefits and to what extent, and who would be hurt by the subsidy's elimination. And of course, with those subsidies that benefit wealthy individuals and corporations almost exclusively, we must ask the difficult questions of whether any national goal at all is served by continuing the subsidy, whether windfall profits are being earned at the Government's expense (thus ultimately at taxpayers' expense), and to what extent the equity and progressivity of the whole tax system is undermined by continuing the subsidy.

Certainly, at a minimum, those subsidies that concentrate benefits in the higher-income brackets must be examined with great care: they are, by their very nature, suspect. If the Federal Government is going to spend money to support or reward certain activities, it does not make sense to do so under a system which provides the highest benefits to those with the highest incomes.

PRESIDENT'S TAX PROPOSALS

It is ironic that at the same time the President proposes to cut Federal spending, he does not propose a reduction in, much less the elimination of, a single tax expenditure.

Senator MONDALE. He does. He proposes the elimination of the low-income-worker's tax bonus. That is the one he cuts out.

Miss BANNON. Moreover, the tax proposals of the President would disproportionately reward high-income corporations and individuals; the earned income credit would be discontinued, payroll taxes would rise significantly and additional stock ownership, estate tax and accelerated depreciation incentives would be instituted. The Council on National Priorities and Resources believes that the President's tax proposals are without merit, and would be positively harmful to poor and middle-income workers.

PRINCIPLES OF TAX REFORM

A general principle in reforming the tax code should be to eliminate those deductions, credits, and deferrals that are available only to the wealthy and hence distort the progressivity of the tax structure, and those that do not serve any legitimate Government objective. By repealing those loopholes, tax rates on all citizens could be dramatically reduced, and important Government services could be more adequately funded.

Perhaps most important is to evaluate tax expenditures against their possible alternatives—specifically as opposed to direct Govern-

ment expenditure programs. There are a variety of ways to provide Government financial assistance—direct grants, loans, interest subsidies, guarantees of loan repayment or interest payments, insurance on investments, and tax incentives. Given a congressional decision to provide assistance to a particular group, Congress should decide how to furnish such assistance with more careful consideration than it has in the past, and not automatically enact a new tax expenditure. Tax incentives should be enacted only when they can be demonstrated to be the best and most efficient way of meeting a goal.

The Budget Committees have a unique opportunity to analyze tax expenditures in just such a fashion. It is fortunate that the Budget Reform Act realized the importance of overseeing and controlling the tax expenditure budget, giving the Budget Committees significant responsibility and authority for recommending changes. In line with this important mandate, the Budget Committee, and the task forces on tax expenditures in particular, should look closely at the benefits and impact of tax expenditures. Moreover, to perform the oversight function effectively, the Budget Committees should consider tax expenditures in each functional area right along with direct spending programs in their deliberations and markup sessions.

TAX EXPENDITURES

There are four major principles or criteria by which we believe every tax expenditure should be evaluated—both by the Budget Committees and by the tax committees:

(1) A tax expenditure must, at least minimally, achieve an objective that is considered nationally desirable, whether stimulating the economy or encouraging home ownership or some other purpose.

(2) It must achieve its objective efficiently; that is, it must result in a greater dollar value to the individuals, corporations, or activities involved than is lost to the Treasury through the tax expenditure, and it must be administratively simple to implement and enforce. (DISC is an example of a tax expenditure that fails to fulfill both of these "efficiency" criteria.)

(3) Its benefits must be distributed in an equitable and fair manner. Thus, tax expenditures must not benefit only the wealthy, nor result in windfall profits, nor needlessly benefit those who would carry on the subsidized activity without any tax incentive.

(4) The tax expenditure must not unduly complicate the tax code. The tax system is complex enough as it is, and to have a large number of tax incentives side by side with provisions making up the structure of the tax itself can only cause confusion. A tax system whose innumerable and often needless complexities require the interpretative abilities of thousands of accountants, lawyers, economists, and long hours of work by ordinary citizens is in dire need of simplification, so that it can be quickly understood by everyone.

EQUITY OF TAX SYSTEM

Most Americans agree with the principle that a tax system should be equitable and should tax income and wealth in a progressive fash-

ion, thereby serving to redistribute resources in our society. Stated simply, these notions require that persons in similar circumstances with similar incomes and assets should be taxed alike, and those who have more should pay more than those who have less. In addition, the tax system must implement a sound fiscal policy, since it is by means of altering revenue and expenditure levels (or by adjusting the monetary system) that the Government can influence the Nation's economy. Perhaps most importantly, the tax system must raise revenues adequate to meet the Government's expenditure needs.

Today it is primarily the equity and progressivity of the system that are in question. It is the second feature which insures an important and dynamic redistribution of wealth and resources in the society. Yet, the present tax system, rather than redistributing income to the majority of people at the lower end of the economic ladder, has become a contribution through its many loopholes, to the maldistribution of wealth.

FISCAL POLICY AND TAX REFORM

However, with respect to fiscal policy, too, there are problems caused by tax loopholes. The myriad of tax incentives and preferences in the system today greatly decrease the ability of the Government to maintain control over the management of its priorities—control both over the types of programs it wishes to implement and over the amounts it wishes to spend. The careless enactment and continuation of tax expenditures runs counter to the whole thrust of recent concerns over the ordering of national priorities, and the wise allocation of our resources—resources which we have come to view as limited, and in need of careful management. Tax expenditures are typically outside of expenditure limits placed on the budget by Congress or the President. Almost without exception, tax "clothing" has sheltered all tax expenditures from public review and from potential change or repeal.

The Council on National Priorities and Resources believes that Congress should regularly review and reenact tax expenditures in the same way as direct expenditures—so that each tax expenditure is up for renewal every year. Adopting an annual "review and renew" procedure would, at the very least, insure that tax expenditures receive the attention they warrant.

The Budget Committees provide a critically important forum for this annual review. In fact, given the time devoted to the evaluation of spending programs by this committee, it is absolutely essential to upgrade and underlie the importance of tax expenditures by giving them proportionate consideration.

TAX REFORM PROPOSALS

In view of the many problems with our tax code caused by the huge number of tax incentives, we set forth below some of the most flagrant loopholes and abuses of our present tax laws which should be quickly eliminated. Our list is by no means a comprehensive or exhaustive program for reform. Other tax expenditures not covered here also deserve review. But with the program we recommend, the Nation

would begin to take bold strides in the direction of true equity and progressivity. Notably, the tax package we propose would give substantial tax relief to low- and moderate-income taxpayers by insuring that others pay their fair share and by refunding money through a tax credit mechanism.

Our proposals for tax justice and a more understandable tax code include:

(1) Repeal of tax expenditures providing excessive profits to corporations and serving no national purpose, including the accelerated depreciation allowance, the investment tax credit, and percentage depletion for independent oil and gas companies and hard mineral producers;

(2) Repeal of tax incentives that favor foreign over domestic investment, including deferral of income from foreign subsidiaries, domestic international sales corporations (DISC), and Western Hemisphere and less developed country corporations, as well as changeover from the foreign tax credit to a deduction;

(3) Strengthening the minimum tax concept, elimination of the maximum tax and the $100 dividend exclusion and full taxation of capital gains;

(4) Reform of the individual income tax to replace present deductions and exemptions with tax credits, including a refundable credit;

(5) Integration of the estate and gift taxes as well as the elimination of the generation-skipping trust and the 100 percent estate charitable deduction;

(6) Analysis of the social security payroll tax to determine how the burden of the tax in low-income groups could best be alleviated;

(7) Extension of the tax cut, unemployment compensation, social security and child care provisions of the Tax Reduction Act of 1975.

The tax reforms suggested here illustrate the individual concerns of many of the constituent organizations participating in the Council on National Priorities and Resources. However, while the organizations share a basic concern that the Nation's tax laws must be consistent with the objective of meeting human needs and support the thrust of the proposals presented here, they are not necessarily in a position to endorse or to be knowledgeable about all of the specific reforms presented.

INVESTMENT TAX CREDIT

The investment tax credit was first created as a general stimulative tool in 1962 to spur the economy during times of recession. The credit reduces taxes by a percentage of the taxpayer's investment in machinery and equipment—currently, a 10-percent credit is allowed. Thus, if a business spends $10,000 on new equipment, it may deduct $1,000 from its tax bill. The tax incentive is meant to encourage plant modernization and expansion, in order to increase productivity and employment.

There is little question that the investment tax credit has been an aid in stimulating investment. The question, rather, is whether it has been directed at those areas of the economy and at those industries in greatest need. Many factors indicate that it has not been. Investment in machinery and equipment is not necessarily a top priority need during depressed economic periods. Efforts should be directed toward

creating and stimulating employment and toward labor intensive industries: heavy investors in machinery are not necessarily large employers. In fact, plant expansion during high unemployment is often useless because businesses are already operating at less than full capacity and cannot hire enough workers to even utilize existing machinery. Increase investments in such a situation may help alleviate future bottlenecks, but little is achieved in immediate relief to the unemployed. The employment agrument is further weakened by the fact that increased productivity through modernized equipment is more likely to result in fewer workers employed than before.

There are naturally indusrties which can benefit from additional and modernized equipment and increase their employment level, but the investment credit is not limited to such areas. Direct subsidies to needy industries and geographical areas are a much more efficient and economical way of achieving the credit's purpose. Direct and selective assistance insures that the right businesses are being helped without a tax giveaway to undeserving industries.

The investment tax credit is a waste of taxpayers' money anytime the credit is used for normal replacement of machinery. Even plant expansion is generally a response to increased levels of demand, so that often the credit is simply a bonus to businesses who would be making the same investments without the credit.

The use of the investment tax credit as a countercyclical tool to spur investment has been seriously questioned by many economists. The little data that exists indicates that the primary effect of the investment tax credit comes after a recession—in fact, in the middle of the recovery. By adding to the crest of economic expansion, the credit may actually be harmful.

The investment tax credit is also inequitable because of the types of businesses it excludes. It does not cover construction, which in many industries is an important part of expansion and modernization. Likewise, it does not help the depressed housing industry. But more importantly, the tax credit excludes many businesses simply because it is a stimulus conducted through the tax system. Many taxpayers cannot take advantage of the credit because they do not pay taxes: without a tax bill, one cannot receive a tax credit. This includes businesses which are just beginning or ones that are failing, who are not making enough money to incur a tax liability. These are the businesses which are most in need of aid, yet the credit bypasses them. Tax-exempt businesses and nonprofit organizations, such as hospitals and Government organizations do not receive any benefits from the investment tax credit either.

The investment tax credit will constitute a loss to the Treasury of $1.5 billion in 1977. Considering the many problems with the credit, this is an immense and unjustified waste of the American taxpayers' money and it is the taxpayer who eventually pays for others' tax breaks. Congress should move to repeal this unfair tax expenditure and consider alternative ways of stimulating those portions of the economy most in need of assistance.

ASSET DEPRECIATION RANGE

The asset depreciation range tax allowance was originally designed as a companion tax expenditure to the investment tax credit. Directed

exclusively at relieving taxes on business investments, it has even less merit than the investment credit. ADR sets useful lives for business assets as a guide for computing depreciation deductions. The guidelines originally established in 1962 were deliberately shorter than the actually lives of assets, as an investment incentive and to give businesses the benefit of the doubt in estimated lives. A ratio reserve test was set up to allow for shorter or longer lives for business whose asset retirement practices differed significantly from the guidelines.

TAX DEFERRAL

In 1971 the ADR system underwent changes in which completely removed its justification as an accounting device and made it simply a tax giveway. Asset lives were reduced 20 percent, which leaves no correlation between the actual life of an asset and the life used in allowing depreciation deductions. The reserve ratio test was abolished, so that there is no allowance for individual business variations. The result is that companies spread deductions over a short period, which gives very substantial tax benefits during the depreciation range period. The defenders of ADR contend that it is merely a tax deferral—large deductions taken immediately mean no deductions in later years. But a tax deferral is not a mere technicality—it represents an interest-free loan to the taxpayer. The money saved is available for increased investment and profit. Furthermore, as businesses continue to acquire assets, the free loan is continually renewed. As Harvard tax expert Stanley Surrey explains it.

> In a stable business, as each assets is replaced, the deferral of tax on that asset offsets increased taxes on other assets as their deferral is ended, so that the original deferral in effect is never made up. In a growing business, the additional assets contribute still more deferral. (Surrey, "Pathways to Tax Reform," 1973).

Proponents or ADR who admit to the benefits of the deferral resort to other arguments in support of the tax break. One claim is that assets cost more to replace because of inflation, so businesses need a compensatory tax bonus. One wonders if these supporters are aware that everyone is affected by inflation, but not everyone receives a tax break to make up for it. Another argument brings up the double taxation issue—the fact that corporate income is taxed first to the company and again to the shareholders when it is given out in dividends. This supposedly justifies an unrelated tax break. Defenders also claim that other countries have liberal tax laws for business investment so American companies deserve the same advantages. Of course, other countries also have much more progressive and equitable taxes on individuals—yet we have not changed our laws to conform to theirs. Not only do none of these defenses have much logical support, ADR should not be used as a solution to these problems. If a problem indeed exists, it should be handled directly rather than giving indiscriminate tax relief through ADR.

INCENTIVE FOR MODERNIZATION

The other defense of ADR is the same as for the investment tax credit—it is needed as an incentive for modernization and expansion. This argument is subject to the same weaknesses described in connec-

tion with the credit, and certainly two methods shouldn't be used to achieve the same goal. Again, if industries are indeed in trouble, the most sensible solution is to utilize direct subsidies. Thus, the asset depreciation range should be returned to its function as a realistic measure of asset lives. It is time to put a stop to such exorbitant revenue waste.

Unfortunately, the administration has decided not to include ADR in its list of tax expenditures, stating that it is a "reasonable" depreciation allowance and thus not a subsidy. We believe such a large tax break—which allows "asset lives" much shorter than industry averages—should be included in the tax expenditure budget. The present ADR loophole was responsible for a loss to the Treasury of $1.6 billion in 1973.

PERCENTAGE DEPLETION

Despite the recent changes made in the oil depletion allowance as part of the Tax Reduction Act of 1975, the depletion allowance remains fully in effect for tens of thousands of oil, gas, and mineral producers.

Percentage depletion allows the producer of oil, gas, and other minerals to deduct 22 percent of the income derived from production in computing taxes. Just as unfairly, it allows landowners to deduct from U.S. taxes the same percentage from royalty income, those payments made to him by mineral companies in exchange for drilling.

Because the deduction is computed as a fixed percentage of sales, up to 50 percent of the net income from a property, those mineral producers with the greatest profit receive the greatest benefits from the subsidy; those on the verge of bankruptcy and with low profits—those most in need of Government assistance—receive little or no benefit from the allowance.

The percentage depletion loophole is an expensive one, given the large amounts of money it channels to large oil firms. Percentage depletion deductions against domestic production allow oil companies to deduct, on the average, approximately 16 times the total dollar cost of the wells. The revenue loss to the Treasury totals $575 million, even after the major reduction made by the Tax Reduction Act.

The present system of percentage depletion allowance has two major effects, according to a 1969 study of the Treasury Department: (1) It lowers the price of oil and gas, thereby stimulating public demand, and (2) it provides higher profits and royalties to landowners, foreign states, and oil companies. Neither of these results would seem to be in the public interest at a time when we are trying to restrict petroleum consumption, and when oil company profits are at unprecedented high levels. Moreover, a major justification of the perecntage depletion allowance—that it provides the large quantities of the capital needed to discover and produce oil—would seem to be superfluous: Companies with high profits and the potential of even higher profits already possess the requisite incentive for production. Domestic oil exploration and development is at record highs, due largely to the marketplace incentive of increased crude oil prices. Although percentage depletion was cut from 27.5 percent to 22 percent in 1971, drilling footage in 1974 totaled 158 million feet compared to an annual average of 149 million feet in 1967–69, and overall exploration and development expenditures were at an alltime high.

INDEPENDENT OIL PRODUCERS

Moreover, whatever justification there was for the percentage depletion allowance when originally enacted, that justification has been critically undermined by recent congressional action repealing the allowance for "large" oil and gas producers while still leaving it intact for producers earning millions of dollars of profits each year. Independent oil producers as defined in the tax cut bill are not small. A firm that produces 2,000 barrels of oil per day, the cutoff size, will usually earn about $7.5 million per year, a figure which places the firm in the top 1 percent of all U.S. firms. Moreover, today the independents are getting the highest prices, earning the highest profit margins, and paying the least taxes of all oil firms. Their typical rate of return on equity capital is a whopping 25 percent. Because of the now selective nature of the oil depletion allowance, independent producers are not only making high windfall profits but stand to make still higher profits as large producers raise oil prices to compensate for the loss of percentage depletion.

There is no rational justification for granting percentage depletion to independent oil and gas producers (for up to 2,000 barrels per day of oil or 6 million cubic feet of natural gas). The amount of tax-free income thus exempted comes to $1,606,000 per year.

TAX LOOPHOLE FOR HARD MINERAL PRODUCERS

The fundamental defects of percentage depletion become clear again when analyzing the tax loophole it provides to the producers of hard minerals—coal, metals, et cetera. Originally extended to coal and other minerals to make them more competitive with oil and gas, the percentage depletion was later liberalized still further to provide tax relief to producers of clam and oyster shells, sand and gravel, stone, et cetera. It is arguable that with oil and gas depletion eliminated, equity considerations demand the same sort of cutbacks in the allowance for hard minerals. Moreover, as with oil and gas depletion, the percentage depletion system fails to provide encouragement or incentives to those producers most in need of help; the system discourages efforts to conserve scarce resources, as well as efforts to recover minerals from the sea or to recycle used materials.

DOMESTIC INTERNATIONAL SALES CORPORATION

The Domestic International Sales Corporation, commonly known as DISC, is a device for reducing the income taxes of firms that export U.S. products. Technically, the DISC program involves the "deferral" of taxes on one-half of a DISC's export profits—but in practice the deferral of taxes has amounted to complete forgiveness of tax liability. Because of the windfall benefits made available to corporations under this tax subsidy, many large U.S. firms have spun off special export subsidiaries in order to take advantage of the tax gimmick and substantially cut their tax bill.

When enacted in 1972, DISC's were intended to encourage the export of domestic products and, in that way, to remedy our adverse balance-of-payments problem. Thus, the DISC provision directly counteracts other tax incentives—for example, the deferral of income

from foreign subsidiaries) with the opposite goal—that of stimulating foreign investment. The elimination of the one would eliminate the excuse for the other.

DISC CAUSES REVENUE LOSS

Fortunately, when the DISC mechanism was created, an evaluation report was required by 1975. Both the Treasury and the Office of Management and Budget have concluded that the DISC tax expenditure should be eliminated. The revenue loss resulting from DISC has gotten totally out of hand. When enacted, the Treasury projected its cost to be $170 million in 1973; in fact, the cost in that year turned out to be $770 million. The Treasury Department estimates that DISC will cost taxpayers as much as $1.4 billion this year and $1.6 billion in 1977.

What's worse, these huge amounts of money do not even appear to be accomplishing any reasonable objective. From March 1972 to March 1973, the first full year for which data are available, the DISC program produced only about $400 million in additional dollars of foreign exchange—but at a program cost of $650 million. Paying $650 million to produce and export goods that earn foreign exchange of only $400 million hardly qualifies DISC as one of our efficiently run Federal programs. In 1974, OMB estimates that the United States paid $2.6 billion to produce $1.6 billion in foreign exchange; yet, there is no proof that this $1.6 billion would not have been generated anyway. This contribution of DISC to increased export sales has not ever been convincingly demonstrated.

DISC BENEFITS SHOULD BE TERMINATED

Not only the great cost but the inequity of DISC argue for its discontinuation. In 1972, over 80 percent of the 2,249 DISC's owned by very large companies earned 22 percent of all DISC profits in that year. Small business firms received almost no benefits from the DISC deferral.

Given recent changes in international economic relations—especially the adoption of a floating rate monetary system—the original justification for DISC has all but disappeared. Our balance of payments problem, largely the result of our overvalued U.S. dollars in the 1960's, has been alleviated, if not cured by the dollar devaluations of 1971 and 1973 and by the adoption of the floating money standard, so that we are now able to maintain a balance of payments equilibrium without artificial subsidies like DISC.

The fact that DISC is seen by some foreign countries as discriminatory and hostile to International Agreements on Tariffs and Trade (GATT), which outlaw export subsidies, adds further weight to the case for DISC's elimination. By artificially lowering the attractiveness of exports to large corporations, DISC has not only hurt the trade position of foreign countries, but has arguably hurt our domestic economy as well. DISC was partially responsible for spurring unwanted international sales of agricultural products in short supply—wheat, soybean, lumber, fertilizer, and animal feed. Due to high foreign demand, corporations receiving DISC benefits ended up with high

profits and high subsidiaries; consumers simply ended up with high prices.

There is no longer any compelling reason—if there ever was one—for the United States to continue to subsidize large and wealthy corporations in a wasteful and economically inefficient fashion. International and economic policy considerations add further arguments against continuation of DISC. We therefore support the immediate termination of this tax expenditure.

EARNINGS OF OVERSEAS SUBSIDIARIES

Foreign source income of domestic corporations is more likely to escape taxation due to inequitable tax treatment than nearly any other kind of income received by U.S. citizens or corporations. It is primarily due to favorable tax treatment of foreign incomes that oil companies in 1974 paid only 12 percent of their multibillion-dollar incomes on the average in taxes, and most other corporations a percentage of income well below 25 percent. Moreover, the greater the income of a multinational corporation, the more likely it was to benefit from the foreign subsidies in our tax laws, and the greater a tax break it received.

One of the major tax loopholes through which multinational corporations managed to evade paying more than minimal U.S. taxes was through operating in the form of foreign subsidiaries. Under U.S. law, the income of foreign subsidiaries is not taxed until distributed or repatriated to the U.S. parent corporation as dividends. Thus, if these earnings are reinvested, or invested in third countries, a corporation can escape U.S. taxes on the income completely.

Recommendations that this tax expenditure be dropped from our tax laws have been made for some time. The Treasury advocated outright repeal in 1962. It makes sense to eliminate this foreign tax preference on the grounds that it serves no useful purpose to subsidize foreign investment over domestic investment while draining the Nation of needed revenues.

By subsidizing the export of technology and productive facilities—which, in turn, makes necessary the importation of goods produced by these facilities—the preference needlessly exacerbates the Nation's balance-of-payments deficit. Given the high unemployment rate here in the United States, it is particularly crucial that we stop encouraging companies to expand overseas rather than at home where jobs are needed.

We believe that tax equity and basic notions of rationality and efficiency demand that earnings of overseas subsidiaries of domestic corporation should be taxed on a current basis.

FOREIGN TAX CREDIT

Another major tax expenditure benefiting wealthy multinational corporations at the expense of the taxpaying and working public is the foreign tax credit. The tax credit, like other subsidies for foreign investment and income, contributes significantly to making corporate investment abroad more attractive than investment at home. By allowing a dollar-for-dollar credit for foreign taxes on a company's U.S. income

tax bill, we do more for a large multinational corporation than we do for the small businessman in this country. A U.S. business that pays State and local income taxes, property taxes, real property taxes, sales taxes, and value-added taxes, is allowed only a deduction for such taxes. Large multinational firms, on the other hand, are allowed a credit for foreign income taxes, a subsidy worth roughly twice as much.

The case has been persuasively made that the tax credit serves to export job opportunities needed domestically and contributes to our balance-of-payments problem. The real issue, though, is whether there is any important national objective served by forgoing revenue to foreign governments.

Discrimination in favor of foreign investment cannot be tolerated at a time when domestic unemployment is so high—and at a time when some feel the need for domestic capital investment is so great. The foreign income tax payments of U.S. corporations should be treated just like the taxes paid on domestic operations—as deductible costs of doing business.

FOREIGN TAX CREDIT OVERALL LIMITATIONS

One method of calculating the foreign tax credit, which adds to its injustice, is the overall limitation. Under the overall limitation method (as opposed to the per-country limitation), total earnings and losses from all foreign countries in which the company operates are aggregated, as are all foreign taxes. By lumping together all income and all taxes, a corporation can use credits from countries with high tax rates (such as Sweden or the Arab countries) to offset U.S. taxes due on income from low tax countries (Australia or New Zealand). In effect, this means that high tax countries, rather than the United States, are collecting taxes on income earned in low-tax jurisdictions.

Certainly, we do not want companies to be required to pay full taxes to two or more different countries. Yet, it is senseless to encourage companies to arange subsidiaries and branches in such a way as to avoid all U.S. taxes. There is no national interest that dictates we give massive tax breaks to corporations simply because of the fortuitous circumstance that they do business in a certain set of countries. Nor is there any reason to give high tax countries those taxes we would otherwise have collected. Thus, at a minimum, if the foreign tax credit is not eliminated, the overall limitation method of calculating the foreign credit should be phased out.

TREATMENT OF ROYALTIES

Payments made by oil companies to OPEC nations should be classified as royalties and be treated as deductions on the companies' U.S. taxes. By claiming such fees as income taxes rather than royalties, multinational oil companies have been able to credit their U.S. tax bill for the amount paid, and thereby realize huge profits without having to pay correspondingly high taxes. In fact, this provision is one of the main reasons major oil companies with billion dollar incomes paid as little as 2 or 3 percent of their income in taxes.

Excess tax credits generated from oil production—even after offsets allowed under the overall limitation for low taxes paid to other coun-

tries—totaled almost $1 billion in 1971 and undoubtedly much more in the last few years of immense oil industry and oil country profits. There is no good reason for the United States to continue to subsidize high profit companies in this manner at such exorbitant and wasteful cost to taxpayers.

OTHER TAX PREFERENCES FOR FOREIGN SOURCE INCOME

There are two other tax subsidies accorded foreign source income which ought to be eliminated: (1) The 14 percent reduction in the U.S. tax rate for Western Hemisphere trade corporations, and (2) the deduction for foreign income taxes which is allowed less developed country corporations.

Western Hemisphere trade corporations benefits were originally instituted in response to the immense tax burden imposed on a few corporations doing business in Latin America in World War II. The effect today, however, is to provide unwarranted and unneeded subsidies to U.S. firms exporting products to Latin America and to those engaged in natural resources activities in Latin America. In fact, of the $346 million cost of this subsidy in 1972, $196 million or 57 percent went to mineral industries—chiefly to the oil corporations.

Compounding the inherent inequities of the tax expenditure, a broad IRS interpretation has allowed corporations to obtain the Western Hemisphere benefits even on goods manufactured outside this hemisphere, simply by manipulating the title of goods sold.

The Western Hemisphere tax gimmick serves mainly to complicate existing corporate tax law without providing substantial benefits to the Nation. It is only reasonable and internationally prudent that income from all foreign sources be taxed at the same rate, and that Latin American countries not be favored over other nations.

Similar reasons exist for repealing less developed country corporations' (LDCC) deductions. Presently, the earnings of LDCC subsidiaries, like those of other subsidiaries, can be deferred indefinitely. In addition, though, foreign taxes paid on the dividends of subsidiaries, when transmitted to the parent corporation, receive both a credit and a deduction on U.S. taxes.

It would seem much wiser to extend U.S. subsidies to those underdeveloped and Latin American countries we wish to assist in the form of direct loans, grants and technical assistance. Not only could such assistance be better targeted and more closely alined with our international interests, but it would very likely be more effective in helping underdeveloped nations achieve well balanced growth.

MINIMUM TAX

The Federal tax system is so riddled with tax exclusions, deductions, deferrals and preferential rates that some taxpayers manage to end up with little or no taxable income. The wealthy individual, with good accounting advice, can invest in bonds, business ventures, and in capital for the sole purpose of sheltering his income from taxation. Corporations can also take full advantage of tax preferences to the extent that their final tax bill is negligible. The "minimum tax," enacted in 1970, was a token effort by Congress to rectify the situation.

It acknowledges that everyone should pay at least some tax, but the law is so weak that it is next to ineffectual.

The minimum tax is calculated by adding up certain areas of nontaxable income: The excluded part of capital gains income, accelerated depreciation on real estate in excess of straight-line depreciation, percentage depletion allowance, rapid amortization of certain investments, and excess reserves for bad debts. From this total is subtracted the taxpayers' regular tax plus $30,000. A 10-percent tax is imposed on the remaining amount.

It is obvious why the minimum tax has done little to alleviate tax injustice. In 1971, after the tax was enacted, there were still nearly 500 individuals with incomes over $100,000 who paid no taxes whatsoever, including several millionaires. The tax preferences covered by the minimum tax are by no means the only loopholes available; the tax should be extended to the many other kinds of excluded income in the tax laws. Moreover, the subtraction of the regular tax paid from the total of the preference items greatly cripples the tax's impact. More reasonably, the minimum tax should be a supplemental tax to the regular tax, since the fact that someone is paying normal taxes should not shield him from taxation on otherwise excluded income.

TAX PREFERENCE PROBLEM

The $30,000 floor is unreasonably high, expecially when the taxpayer's regular tax has already been subtracted. It is far too large an amount of money to escape taxation. The minimum tax is meant to affect taxpayers who derive a substantial amount of income from tax preference interests, but a person who has even $10,000 in excluded income is not exactly a member of the lower income classes. Imposing the minimum tax on all preference income above $10,000 at most would be more appropriate.

Another problem with the tax is that it is not progressive—the 10 percent applies whether the taxpayer is earning $30,000 or $300,000 in preference income. It has no relation to normally taxable income—in fact, because of the substraction of the regular tax in computing the minimum tax, as taxable income rises, the amount of preference income subject to the minimum tax is decreased. This is completely contrary to the principle of progressive taxation, particularly when the normal rate for most of the taxpayers affected by the minimum tax is as high as 70 percent.

In a truly equitable tax system, there would be no need for a minimum tax. It is a shameful admission of the fact that our tax code invites widespread exploitation. Ideally, this should be rectified through the repeal of the unfair tax expenditures. But until that goal is reached, the minimum tax should be strengthened by lowering the floor, enlargnig the list of preference items, making the tax progressive, and making it an addition to the regular tax. Several billion dollars in revenues would be generated through these changes, compared to the more $335 million raised by the minimum tax in 1970.

MAXIMUM TAX

In 1969, Congress arrived at an interesting recognition of the problem of tax preferences. They saw that unearned income was

benefiting from all kinds of tax breaks, so rather than attacking these tax breaks they decided earned income should have its share of relief too. The "maximum tax" was established, which places a 50 percent tax rate ceiling on earned income.

The House Ways and Means Committee explained that the maximum tax would: "Reduce the incentive for engaging in (tax avoidance) activities by reducing the high tax rates on earned income." It is an unreasonably optimistic view of human nature to presume that presenting someone with an easy method of tax reduction will lull him into ignoring the more complex ways of escaping taxes. The maximum tax is simply an extra bonus handed to the wealthy taxpayer, serving to further reduce his tax burden.

TAX RATES BASED ON TOTAL INCOME

While at first glance it may seem reasonable that no one should have to pay more than a 50 percent maginal rate on earnings, closer analysis reveals that such concern is misplaced. Nearly anyone earning enough to worry about paying higher than a 50 percent rate also has income from unearned sources—income which is subject to little or no taxes. Thus, while an individual may indeed be paying 50 percent on a large salary, he may be paying no taxes on income excluded or reduced through tax expenditures. In this case the overall tax rate may actually be as little as 10 or 20 percent.

The maximum tax is not founded on any logical evaluation of the tax system. It singles out earned income for special tax treatment, but total income is the only valid base on which tax rates should be imposed. With all the special tax preferences available to the rich, it is an extremely rare taxpayer who pays more than a 50 percent overall rate. If serious tax reform is enacted so that unusually high overall rates become a problem, this can be rectified through a change in the basic rate structure. As of now, however, the maximum tax on earned income should be immediately repealed.

$100 DIVIDEND EXCLUSION

Current tax law permits a taxpayer's first $100 of dividends from corporate stock to be excluded from taxable income. While this is one tax expenditure theoretically available to lower income taxpayers as well as the wealthy, most of the benefits are still realized by those in the upper income brackets. This is simply because most stockholders are in the higher income range. In fiscal year 1974, 57.5 percent of the benefits went to 14.6 percent of the taxpayers—those with incomes over $20,000.

There is no reason for the Government to favor this select economic activity over others. It should not be the Government's role to encourage investment in stocks over, for example, investment in savings accounts. Repeal of this tax expenditure will save the Treasury $350 million.

MARITAL STATUS AND INCOME TAXATION

Despite the reforms made in 1969, the current tax rate scheduling procedures continue to discriminate against both single and married persons, particularly when both partners work. Certainly different

people have differing living expenses and obligations, but individual responsibilities should be accounted for through the allowance of tax credits rather than through the use of different tax rates based on marital status. Congress must reevaluate the split-income concept implemented in 1948 and must respond to the need for a tax schedule with a single rate that will be applicable to each level of taxable income.

Joseph Pechman and Benjamin Okner estimated that income splitting (and the special rates for heads of households that are part of it) costs the Treasury over $21 million per year (at 1972 levels). More significantly, 97.5 percent of these tax benefits go to taxpayers with incomes above $10,000 since low and moderate income taxpayers receive virtually no benefit from income splitting.

SINGLE TAXPAYER PAYS MORE

The 1969 act reduced the penalty on single taxpayers who do not have the advantages of income-splitting by 20 percent, but the individual taxpayer (never married, widowed, divorced, or married but filing singly) still pays on a sliding scale up to 20 percent more than couples who can split their incomes.

Simply stated, there is no logical reason to continue the present system whereby a single person must pay more in taxes than a married couple with an identifiable amount of taxable income. The 16th amendment did not tax people. It taxed income from whatever source derived. Clearly it does not imply that one shall be taxed according to marital status.

Although the income-splitting concept is defended as an aid to those with child rearing responsibilities, under present law single persons filing as heads of households are unfairly penalized. A single parent earning $8,000 pays $100 more in taxes than the married couple with one income. At an income of $16,000 this penalty rises to $280 (regardless of whether the couple has any dependents).

TAX ADVANTAGE TO ONE-INCOME FAMILIES

As a result of changes in Federal tax law in 1969, married couples who both work now pay higher taxes than if both were single. Certainly this tax structure which, intentionally or not, favors those families with only one working partner, must be adapted to the realities of today, when often both partners work either by choice or by necessity. While the need for extra funds is felt most heavily in the lower income brackets, the law bestows its greatest advantages on the middle and upper income groups. The advantage is given principally to one-income families and not to those in which the wife's income is a significant supplement.

Clearly, review of the tax structure is needed to insure that tax rates do not penalize single individuals or handicap those families with two or more workers. Although the substitution of tax credits for present deductions and exemptions, as recommended in the next two sections, will alleviate most inequities, alterations in the tax rates will probably also be needed.

ITEMIZED AND STANDARD DEDUCTIONS

The present system of deducting certain personal expenses from gross income, or alternatively using the standard deduction, is a regressive factor in our tax system. This occurs because of the way deductions are tied to the marginal rate structure. If an individual in a 70-percent tax bracket gives $100 to charity, $100 is excluded from the income on which he would normally be paying $70 in taxes. Therefore, his $100 contribution has actually cost him only $30. On the other hand, a taxpayer paying at a 14-percent rate saves only $14 by deducting the same $100 contribution. Why should identical contributions (or medical expenses or mortgage payments) be so much more advantageous to the wealthy taxpayer?

SYSTEM OF TAX CREDITS

This inequity can easily be changed by substituting a system of tax credits. The credit is computed as a percentage of the itemized expenses and then subtracted from the individual's tax bill. Using a 25-percent credit, a $100 charitable contribution would subtract $25 from the taxpayer's total taxes, regardless of his tax bracket. This means equal credit for equal expenses. High income taxpayers will still receive more credit than those with lower incomes but only because their personal expenses are generally larger.

Taxpayers using the standard deduction rather than itemizing expenditures would instead receive 25 percent of the deduction as a credit. This gives some tax relief to lower income taxpayers, who most often use the standard deduction.

A 25 percent credit for both the standard deduction and itemized deductions would have a neutral effect on revenues. Translating into greater savings for lower income taxpayers and less for the wealthy, it is a redistribution of benefits rather than a total gain or loss.

REFUNDABLE TAX CREDIT

The $750 personal exemption is another regressive tax provision. Again because of the marginal tax rate, a $750 exclusion is worth $525 to someone in the 70 percent bracket, but only $105 to a person in the 14 percent bracket, while to an individual so poor he pays no tax, it is worth nothing. The exemption should be converted to a credit, and it can at the same time be a major tool for tax relief and restoring progressivity to our tax system. As a refundable credit of $250, when the credit exceeds the tax liability, the difference would be paid to the taxpayer by the Government.

COUNTER-RECESSIONARY TOOL

Current measures for helping the poor in our society have proved to be inadequate and limited. There are still many families living well below the poverty level, because they are ineligible for Government assistance or do not receive enough to meet their needs. This is particularly true with today's phenomenally high unemployment rate. A

refundable tax credit for each taxpayer and dependent would add considerably to the incomes of those with little or no money. Moreover, putting money in the hands of those less well off is an important counter-recessionary tool, because it goes right back into the economy through consumer purchases.

The $250 credit would provide relief to the middle income taxpayer also—in fact, taxpayers up to the $20,000 income bracket would benefit from the credit. Middle income wage earners now bear an unfairly heavy tax burden. They don't have money to take advantage of tax expenditures, and they suffer the most from the regressive social security tax. Tax relief for these individuals is long overdue.

The cost of the refundable tax credit would be large—the 1974 estimate was $13 billion—but the closing of major tax loopholes would more than compensate for this loss.

CAPITAL GAINS

Under the capital gains provisions of the tax code, only half of the gains on capital assets (real estate, stocks, and equipment) held more than 6 months are included in the income of an individual. The other half is deducted from income and thus never taxed.

Although special treatment of capital gains results in a huge loss of revenue annually, it is not included in OMB's tax expenditure analysis because of "practical problems" involved in identifying and taxing unrealized capital gains. Yet it is estimated that this 50 percent capital gains exclusion costs the Treasury about $7.4 billion per year—more than any other single tax expenditure.

What's worse, most of the benefits of the capital gains tax breaks go to the wealthy. A full two-thirds of the benefits go to the 1.2 percent of taxpayers with incomes exceeding $50,000. This is because it is largely the wealthy who own stock; 78 percent of all Americans cannot afford to own stock, according to a 1971 University of Michigan survey. The last round of inflation may have cut down even further on the small group of wealthy taxpayers who stand to benefit from the capital gains exclusion.

Thus, it is not surprising that Treasury Department statistics indicate that taxpayers with incomes of $10–15,000 received, on the average, $19.06 from the exclusion, those with incomes over $100,000, an average of $19,431 per taxpayer.

CAPITAL GAINS COMPENSATES INVESTORS FOR INFLATION

One argument typically made in favor of capital gains preferences is that it compensates the investor for inflationary, as opposed to real, increases in the value of an investment. It is noteworthy, however, that no other form of income receives such an adjustment. There is no logical reason to single out capital assets.

The inequity of the capital gains exclusion clearly argues for its repeal. There is no reason why income from assets should be favored over earned income. Capital gains should be subject to full taxation just like wages. In addition, appreciation of capital assets should be taxed at death, with some exceptions and exclusions for surviving spouses, farms, and family businesses.

POLITICAL ACTIVITIES OF FOUNDATIONS

Privately supported charitable and educational organizations are granted exemption from taxation principally under section 501(c)(3) of the Internal Revenue Code. In order to maintain this tax-exempt status organizations must comply with the requirement that "no substantial part" of their activities is devoted to influencing legislation of campaign activities. It has long been recognized that there is no specific test or other reasonable means of ascertaining the meaning of the word "substantial" as it is used in this section. Several attempts to clarify the situation in the past have proved unsuccessful. The 1969 act (26 U.S.C. 4925) also imposed a 10-percent tax on each taxable expenditure of a foundation. Taxable expenditures under the act basically include money spent "on any attempt to influence legislation * * *" Together these limitations on influencing legislation are so broad, and so costly if violated, that these groups are discouraged from expanding their activities into areas touching upon public policy. In addition, the wording of section 4945 is so broad as to suggest that any attempt to affect the opinion of the public on any matter that might conceivably relate to legislation might incur penalties.

These strictures adversely affect the freedom of foundations and other groups to contribute to the general welfare. In the past, foundation-sponsored programs and activities have often led to a recognition that changes were needeed in local or national conditions and that new legislation was required. It is clear that the legislative intent was to prevent foundations from engaging in partisan politics. In light of this purpose, modifications should be made so as to enable the language of the law to reflect more accurately the desires of Congress and leave room for legitimate functioning of foundations on behalf of the general welfare.

While charitable and educational organizations are limited by the "no substantial part * * *" requirement, business organizations, trade associations and unions have the right to engage in such activities without quantitative restriction. Congress must now reconsider the ABA recommendation that it pass legislation with respect to tax-exempt organizations. Certainly if the goals of these organizations are such that the Congress has found them to be worthy of tax-exempt status they arguably should be able to use their expertise to influence legislation in promotion of these established goals.

TAX STATUS OF FOUNDATIONS

As a result of the Tax Reform Act of 1969, foundations are faced with the threat of a diminishing capacity to support those charities which are dependent upon them for their survival.

4-PERCENT EXCISE TAX

The 4-percent excise tax upon investment income of private foundations was originally intended to fund the administrative costs of IRS enforcement of provisions affecting the creation, operation, termination of foundations, as well as the flow of their moneys under the

1969 act. In reality, the revenues produced by this tax have been much greater than the cost of administration of all tax-exempt organizations. Unless this distortion is remedied, what was essentially an audit assessment will continue to be, in effect, an indirect tax upon private charity itself. This is contrary to a strong congressional tradition of supporting private philanthropy. While some may claim that 4 percent is not an excessively high tax, it nevertheless establishes a poor precedent for the future. Regardless of whether the foundations can afford the tax, the larger question is whether the private sector can afford such a reduction in funding. The most effective means of dealing with this problem would be prompt establishment of a flexible rate system which would be adjusted from time to time to deal with changes in administrative costs. In the interest of the institutions and persons who are the potential beneficiaries of foundation activity, we urge that the level of the excise tax be adjusted to the real cost of administering the law.

DECLINE IN ROLE OF FOUNDATIONS

The "payout" requirement for private foundations has also had a negative impact. The rate of growth of foundation assets is in fact dependent on their payout rates (grants as a percentage of assets) relative to the rate of return on their assets. The combination of rising costs of foundation-supported activities and the high payout requirements under the act would seem to imply a decline in the future role of foundations. Especially in view of the budgetary restraints on the expansion of governmental social programs, the needs for services which foundations meet are not likely to diminish, and there is urgent need for reexamination of required annual payout requirements and the disincentives to the establishment of new foundations.

Congress has properly mandated that foundations should use their resources for the full benefit of those they are designed to serve. While no foundation would argue with this principle, the law presents problems. Foundation services are highly labor-intensive and offer few opportunities for increased productivity. Therefore their costs of operation rise faster than inflation in other sectors of the economy. This factor coupled with the high payout requirement would appear to indicate the probability of a progressive decline in the real support power of existing foundation funds. Congress must act to lower minimum payout requirements and establish larger transition periods for meeting these requirements. Foundations have been diligent in their adherence to the requirements of the 1969 act, and there is no reason to believe that lowering distribution requirements would result in "hoarding" of funds by foundations. Foundations should not be forced to make greater payouts and settle for investment returns which a prudent investor would find unreasonable. To retain the present rule risks a possibly fatal impact on the future of such organizations.

ESTATE AND GIFT TAX INTEGRATION

In principle, taxes on gifts and inheritances constitute a potential source of equity and progressivity in our system. Levied on wealth

rather than on income, the estate and gift taxes fall primarily on rich. Roughly, 5 percent of estates are subject to estate tax in any year. Two-tenths of one percent of all estates, those in the $500,000 and over bracket, paid 60 percent of the total estate tax bill in 1970, the most recent year for which data is available.

From the standpoint of fairness, the estate and gift taxes serve an important function—that of breaking up vast holdings of wealth and thereby insuring that democracy is not jeopardized by the emergency of self-perpetuating concentrations of wealth. Especially in today's society, characterized by massive holdings of wealth by a few individuals, it is critical to deal with the problem of equitably distributing the Nation's wealth.

TAXING AT DEATH

Taxing the transfer of wealth at death has long been recognized both in the United States and abroad as a sound procedure. Because the estate tax is imposed at death, it is a relatively painless way of raising substantial Government revenues. There is no one who feels sharply the impact of the tax, so that it has minimal effect, if any, on incentives and risktaking. Moreover, it should not be forgotten that the income tax specifically exempts income received by gift or bequest, so that estate and gift taxes fill in a critical gap in the tax system. Moreover, the Treasury Department estimates that between 40 percent and 50 percent of the value of estates represents untaxed capital gains—real estate and other possessions that increased in value while the owner held them, a value which was never subject to income tax during the life of the owner. Given this relationship between estates and income taxation, the estate and gift taxes merely insure that all wealth is taxed at least once in each generation.

EROSION OF ESTATE AND GIFT TAX

Unfortunately, the revenue-raising and equity-producing potential of the estate tax has been seriously eroded by the separate rate schedules of the estate and gift taxes, by the generation-skipping trust, and by the deduction for charitable contributions.

The basic form of the estate and gift taxes has remained generally the same since 1942: separate estate and gift taxes, graduated upward as the value of the taxable estate increases, are imposed on wealth transferred at death. However, because of the separate exemption and rate structures, an individual who allocates a $1 million estate equally between gifts and bequests pays estate taxes of $247,055, while if he passes on the estate entirely through bequest, he pays $75,000 more in taxes, a total of $325,700. Such reductions in tax liability are made possible through liberal exemptions (gift tax exemptions of $30,000 in lifetime gifts plus $3,000 per donee; estate tax exemptions of $60,000) and through generously low gift tax rates, which are 25 percent lower than the already low estate tax rates.

The value of the gift tax incentive rises dramatically with wealth, since not only are the wealthy better able to donate their money to others, but they are able to give more money to more people.

There is little or no value from the Government's viewpoint in encouraging gifts over inheritances in this way. Whether an individual

chooses to give property to his or her children before death should logically be a matter between the individual and his or her children. The Nation is not particularly benefited one way or another.

Given the inequities caused by imposing separate tax and rate schedules on gifts and bequests, and the tax complexities resulting from maintaining two separate taxes, it is our recommendation that the two taxes be combined. One tax rate should be imposed on all gifts made over the lifetime of the donor and on those gifts made before death, with total taxes at death correspondingly reduced.

GENERATION-SKIPPING TRUSTS

One major loophole in the present estate tax which significantly curbs the revenue-generating capacity and detracts from the impartiality and equity of the tax is the generation-skipping trust. By establishing a trust meant for remote descendents, a wealthy individual can transfer money to his grandchildren while avoiding estate taxation. Yet, his immediate family can receive all of the income from the trust fund, along with a healthy share of the principal, and make many of the critical decisions about the disposition and management of the property. In this way, the property—belonging for all intents and purposes to those who manage it and spend it—can escape taxes as many as three times simply because the property is not owned outright.

As a result of this abuse of the estate tax law, control of wealth and property can pass undisturbed from one generation to the next. Three out of every five millionaires transfer a portion of their property and wealth in trust, and half of this property and wealth escapes all estate and gift taxes until the death of the grandchildren or great grandchildren.

The device of the generation-skipping trust—so valuable to families of great wealth—is of limited value to those of moderate means. For a variety of economic reasons, those with small estates must leave their property to their immediate family, since those of moderate means cannot be sure that their wives and children will not need the money for medical or other emergencies. It is not until family wealth becomes so immense that no conceivable emergency could deplete the family's resources, that the generation-skipping trust becomes a valuable and invariably used tax shelter. Thus, while those with great wealth escape estate tax action, those with moderate holdings must pay estate taxes each generation.

SURTAX ON GENERATION-SKIPPING TRUSTS

To remedy the present inequity, the Federal Government should enact a surtax—in addition to the regular estate and gift taxes—on transfers of wealth that skip a generation. Such a surtax—if imposed at a rate equal to 60 percent of the donor's marginal estate or gift tax rate—would to some extent equalize the taxes paid by those who transfer money through use of the trust mechanism and those who are unable to resort to such mechanisms. The Treasury studies proposal of 1969 recommended a 60-percent substitute tax or surtax on generation-skipping trusts in order to collect those taxes that would otherwise be foregone. We support such an approach to the problem posed by the

generation-skipping trust, since it would eliminate the most outrageous inequities of the existing loopholes.

THE ESTATE CHARITABLE DEDUCTION

Provisions in the present estate tax law which allow an estate to take an unlimited tax deduction for bequests made to qualified charities is one feature of the present estate tax framework drastically in need of correction. It is this loophole which allowed Alisa Mellon Bruce, with an estate value at $580 million, to pay taxes less than 1 percent in Federal estate tax when she died, simply because the bulk of her estate went to the Mellon Foundation, a tax exempt charity. A similar unlimited charitable deduction is allowed under the gift tax.

The millionaires who take advantage of this deduction have for the most part retained control over their money even after giving it to charity. This is accomplished simply by transferring the nonvoting stock of a family corporation to a private "family" foundation. By transferring only nonvoting stock to the foundation, the family retains control over the business.

As desirable as voluntary giving to charitable organizations may be, there is little justification for allowing a 100-percent deduction in the case of a transfer to a private foundation. Recently there has been much criticism and questioning in general of the Government's proper role with respect to such charitable organizations, as well as extensive analysis of whether various tax incentives now on the books significantly stimulate voluntary giving in support of charitable causes.

In contrast to the overly generous estate tax giveaway, the income tax limits charitable deductions to 50 percent of income. It would be a relatively modest and sensible change with little impact except on those few millionaires with private foundations, to limit the estate and gift tax deduction to 50 percent of the value of the estate—or the value of lifetime gifts—in keeping with the 50-percent limitation under the income tax.

SOCIAL SECURITY TAX

The current structure of the payroll tax is inconsistent with principles of tax equity and progressivity. Under present law, a 5.85 percent tax—11.7 percent including employer contribution—is imposed on all earnings, up to a maximum base of $15,300—$16,500 in 1977. This setup presents a number of problems to low- and middle-income workers.

For the low-income worker, the social security tax becomes the highest tax he pays, higher than regular income tax. There are no provisions to exempt the poor from being taxed, such as the standard deduction and personal exemption in the income tax system.

Any attempts to alleviate the tax burden of the income tax on those with low incomes are thwarted by the fact that the poor are still suffering an unduly heavy social security tax.

SOCIAL SECURITY TAX INEQUITIES

The social security tax unfairly assumes that equal income means equal ability to pay. The income tax system recognizes that a taxpayer

with dependents should not pay as much as the single taxpayer; equity dictates that the payroll tax should take this into account also.

The middle-income worker is treated unfairly too, since he is paying the same amount of tax as the wealthiest wage earner, since $895—5.85 percent of $15,300 is the maximum any individual is required to pay. At the same time, the middle-income worker does not receive the same benefits in proportion to payments as does the low-income worker.

The inequity of the social security tax deserves special consideration at this point in time, when the trust fund itself appears to be in trouble. For over a year now, from both in and out of Government, there has come a succession of increasingly bleak reports on the soundness of the social security trust fund. The trustees now estimate that benefits will begin outstripping tax collections this year rather than in the 1980's as expected. In fact, if nothing is done soon to increase funding, the trust fund may be exhausted in 1981.

ALTERNATIVES TO STABILIZE THE TRUST FUND

Congress has a number of alternatives from which to choose in order to stabilize the trust fund and in order to make the social security tax more progressive. First the maximum earnings base subject to tax can be increased from its present level of $15,300 to $24,000. This increase of $9,000 in the wage base would return the program to its original intent—that all workers should have their full wages counted toward social security benefits and subject to the payroll tax. Today only about 85 percent of the workers covered by social security have their total earnings counted, while in 1938 the proportion was much higher—97 percent. Moreover, by raising the wage base, the contribution rate would not have to be increased and the security of the trust fund would be firmly established.

Second, employer contributions to the social security system can be increased to comprise more than half of total costs. This is particularly justifiable in view of the fact that the employers' contribution is tax deductible as a business cost while the workers' contribution is part of taxable income. Third, and perhaps most important, the Congress could enact standby authority to use general revenues for the financing of social security whenever necessary. This could be done simply by restoring to the social security law the provision for general revenue financing that existed from 1944–50.

SOCIAL INSURANCE SYSTEM

In the long run, we may do best to follow the example of foreign social insurance systems and enact a combined retirement and health insurance structure financed partly by employer contributions, partly by employee contributions and partly by contributions from the Government, out of general revenues, in recognition of the Nation's stake in, and the critical importance of, a well-functioning social insurance system.

TAX REFORM NEEDED

It is clear that the tax system is in need of major reform, and the Council has outlined a program which would be an important step in

the direction of tax justice. It is hoped that all of the proposals we advance will eventually become part of the tax law, but assuming they will not be enacted this year, it is critically important that the Congress extend the Tax Reduction Act of 1975 through fiscal year 1977.

The tax expenditure concerns of the Council on National Priorities and Resources are directly responsive to our concern for meeting the needs of our country. Comprehensive tax reform along the lines outlined here will go far toward meeting the needs of all Americans for adequate income by alleviating the heavy tax burden that now falls on low- and middle-income workers. We pledge ourselves to continue working with you as you begin to remedy the defects of our tax system, and we welcome the continuation of the dialog begun here today.

Senator MONDALE. Mr. Bade.

STATEMENT OF CARL A. BADE

Mr. BADE. Mr. Chairman and members of the committee, my name is Carl A. Bade. I am presenting this statement on behalf of the U.S. Power and Priority Team and the Economic and Racial Justice Priority Team of the United Church Board for Homeland Ministries.

While no one person in an agency can speak for all of the 1,800,000 members of the United Church of Christ, we do have a reasonable reading of the leanings of the active members in the form of statements by the elected General Synod. After many years of study by the members of the United Church of Christ, the Seventh General Synod in 1969 passed its pronouncement on tax reform entitled "Sharing the Cost of Government Fairly." [1] I would appreciate its inclusion in the record.

TAX LAW REFORM

Mr. Chairman, I am pleased to be here today to offer some views on how the tax laws should be changed in order to encourage sound stewardship of our national resources and a more equitable distribution of their benefits to all. This Bicentennial year offers a great opportunity to establish a more humane and democratic society that is responsive to the just needs of all Americans. If that objective is to be achieved, reform in our tax structure is a prerequisite. Nowhere is the power of the Government more apparent and pervasive than in its ability to levy taxes. The levying of taxes—or who pays and who gets what, is directly related to the concept of social justice—a concept to which we should all be committed.

WIDESPREAD TAX AVOIDANCE

Basic fundamental reform of the tax system is long overdue. The system suffers from widespread inequity and injustice. Recent reports of massive tax avoidance by wealthy individuals and corporations are not only revolting to the majority of hardpressed citizens but they also lead to an erosion of confidence in the fairness and integrity of Government—a confidence that we can ill-afford to lose. Data on the inequities of the present system are so well documented that it is not necessary to recount them here. We sincerely hope that the members

[1] See p. 102.

of this committee are aware of these shortcomings and are seriously committed to address them.

TAX EXPENDITURES

"Tax expenditures," a relatively new concept represents an accumulation of tax preferences, subsidies and exclusions that have been enacted over the past few decades. Although "tax expenditures" cost over $90 billion in 1976, up from $44.1 billion in 1968 it was not until 1976 that such figures were included in the budget. It has been rightly acknowledged that it is only through study of these expenditures that the total impact of the Federal Government on the economy can be measured. Senator Muskie has correctly observed "Tax expenditures cost money, help some people and buy consequences just like any other government expenditures." They, therefore, need to be very carefully scrutinized. A proper understanding of tax expenditures is essential if the Congress is to properly analyze the total budget picture and be effective in the reordering of national priorities. To be sure, the benefits of some tax expenditures fall mostly to lower or lower-middle income taxpayers—for example, public assistance payments and disability insurance benefits are not taxable. For middle-income taxpayers, unemployment insurance and Workmen's Compensation benefits are not taxed. Yet, when studied on a per capita basis, tax expenditures overwhelmingly favor the rich. On the average, based on 1972 estimates, an individual at the $3,000 to $5,000 level received $10 in tax expenditure assistance; in the $25,000 to $50,000 bracket, $1,358; in the $100,000 to $500,000 bracket, $29,264; and in the $1 million bracket, $725,000.

SUBSIDIES

Despite the harsh criticism of tax expenditure they are not all uniformally bad. There are some provisions that are designed to help people meet basic human needs and/or to induce appropriate economic activity. The tax expenditure table makes it possible to look at each listing and ask some very penetrating questions:

—Should the Government be assisting the particular activity as a matter of national priority? Does it serve the major public purpose?
—What are the legitimate goals of the subsidy? Can they be justified today?
—To what extent are these goals being met?
—What would be the real effect of eliminating the subsidy?
—Does the subsidy substantially decrease the ability of the Government to maintain control over the management in its priorities? Does the subsidy run counter to the need and desire to reorder some national priorities?

Negative answers to these questions should result in elimination or severe modification of the subsidy. Subsidies for example, that accrue to the wealthy, that serve no national purpose and that help to perpetuate income inequality and the maldistribution of wealth should be clearly done away with. If the Government decides to spend money to support and reward activities it makes little sense to do so by

providing the highest benefits to those with the highest incomes. "The test of our progress" Franklin Roosevelt once said, "is not whether we add more to the abundance of those who have much. It is whether we provide enough for those who have too little."

Let us now look at some of the major tax expenditure items with the above questions in mind.

CAPITAL GAINS

A major tax expenditure favorable to the wealthy is listed in the tax expenditure table as "capital gain: individual." This item refers to the special treatment of income that results from the sale of appreciated stocks, real estate, oil properties and other capital assets (including certain uses of livestock, unharvested crops, etc.) On this type of income the tax rate is cut in half.

Capital gains mainly benefit the wealthy, those individuals who need the benefits the least. We therefore recommend, as outlined in ref. 2(a) in the General Synod pronouncement that:

> The present preferential treatment afforded most capital gains should be eliminated and such gains should be taxed at the same rates as any other income. Provision should be made for averaging the gains over the years involved to prevent unduly high rates for a single year. It is contrary to most notions of fairness that capital gains income should be taxed at lower rates than income earned as wages or salaries!

BUSINESS TAX SUBSIDIES

The investment tax credit was designed to encourage modernization of plant and equipment, which in turn was supposed to stimulate the economy. While it is one of the most expensive tax expenditures it is quite limited in scope and its overall benefit as a stimulant is being seriously doubted.

We recommend that the investment tax credit as presently constituted be repealed and that the committee should consider alternatives such as direct subsidies to needy and labor intensive industries, as a way of stimulating those segments of the economy most in need.

PERCENTAGE DEPLETION

While tax shelters of any kind and from whatever source run counter to the first principle for tax reform enumerated by the Seventh General Synod, it took a particularly dim view of oil, gas and mineral depletion allowances.

"The preferential treatment extended to taxpayers who invest in oil, gas and mineral properties should be ended . . ."

The Tax Reduction Act of 1975 made some headway in cutting this tax expenditure. Yet the depletion allowance remain fully in effect for tens of thousands of oil, gas and mineral producers.

Complete repeal of the depletion allowance, which has long outlived its declared purpose and usefulness, would go a long way in restoring a sense of fairness and equity to our tax structure. By the same token, it would also help restore some confidence both in Government and in the business community.

FOREIGN SOURCE INCOME

The past 40 years have witnessed an ever increasing number of American companies that are locating abroad. This expansion abroad has severe effects on the U.S. domestic economy in terms of jobs that are lost, technology that is exported and decline in the U.S. balance of trade. Some of the biggest American corporations now have more than half their total employment overseas. Why has this trend been happening? The location of natural resources and the availability of low cost labor are factors in drawing U.S. investment and production overseas. Yet the dollar incentives of tax loopholes are generally recognized as being a major (if not the major) factor. To the extent that the tax laws place an incentive for companies to go abroad to the eventual detriment of the national economy and national needs, they are in direct conflict with the criteria of neutrality enunciated in the General Synod pronouncement. "Taxes should not create artificial incentives for making economic decisions except where explicitly intended as a matter of public policy * * *"

American international corporations presently enjoy the benefits of a long list of tax preferences. The list include the following:

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

DISC, a concept originated by the Treasury and enacted in 1971, as a device for reducing the income taxes of firms that export U.S. products. It was intended to encourage the export of domestic products and by so doing to remedy the adverse balance of payments situation in 1970–71. This provision cost over $1.5 billion in 1976 up from $640 million in 1973. (In 1973 its cost was almost four times more than the projected cost of $170 million).

DISC has outlived their usefulness, they have failed to accomplish their objectives. Furthermore, benefits accruing as a result of the provision, are actually less than the cost of running the program. We support complete repeal of this unjustified tax expenditure. The Tax Reduction Act of 1975 moved in this direction by eliminating DISC benefits for natural resources and energy products. The process should now be completed.

FOREIGN TAX CREDIT

The foreign tax credit offers blatant tax subsidies to the foreign operations of U.S. multinational firms. This subsidy overtly discriminates against business within the United States and provides major incentives to move production overseas. It is actually more profitable to produce abroad than to produce and invest and create jobs within the United States. We support a repeal of the foreign tax credit and its substitution with a simple deduction as a cost of doing business. This is how State and local taxes are dealt with and the concept should be extended abroad.

NEED FOR TAX SIMPLIFICATION

Over the years a whole new industry of tax preparers has grown up because of the increasing complexity of the tax laws. They are even more complex this year than ever before. The law has been significantly

changed with the addition of the new $30 tax credit for each exemption as well as the new earned income credit for low-income families. Other changes have been made, not only in the law itself but also in the interpretations of the law handed down by the courts and in new rulings by the IRS.

This increasing complexity results in the taxpayers failure to understand the law. Returns for 1975 already received by the IRS make this abundantly clear. What is more troublesome is that tax collectors themselves are not clear on much of the new law. A Government operations subcommittee in the House of Representatives learned last December that tax advice given by agents at district IRS offices had been inaccurate approximately half the time.

Senator MONDALE. That is correct.

You know in the Senate we passed a bill, and I strongly supported it to provide an alternative optional tax credit—I think the first bill was $200. Unfortunately in the Congress they just threw that out and gave everybody a $30 credit. And that creates complexities that made it very difficult the next time around to go back to the optional credit approach. All we got was a $5 increase in the universal credit. Then we put in an optional credit of 2 percent of gross income. It is so complex that nobody can follow it now.

Mr. BADE. Unfortunately we lost that because it is more equitable when we are dealing with tax credits as over and against exemptions.

SIMPLICITY IN TAX SYSTEM

One of the criteria which the General Synod considered to be basic to a just tax system was that of simplicity.

The law should be understandable to the taxpayer and relatively easy for both taxpayer and government to administer.

The present analysis of tax expenditure items and the elimination of many of them can help, yet we believe that the whole issue, the need for simplification warrants major attention. Maybe it means revamping almost completely the whole present tax structure and its replacement with a more simple—straightforward mechanism such as a possible graduated gross receipts tax. One thing is certain—allowing the 1040 form to become more complex and the instruction pamphlet longer cannot be justified.

SOCIAL SECURITY

The current debate on the financial soundness of the Social Security System raises a major social policy question for this committee—whether or not to make the present social security tax consistent with the principles of tax equity and progressivity. This issue is at the center of the debate on how to assure the fiscal integrity of the social security trust fund. While the Congress has many alternatives from which to choose we believe that the best way this can be done is by substantially increasing the maximum earnings base for contributions and benefits. Under the existing law which provides for the automatic increase in wages the base would be about $17,000 in 1977. We believe that an increase to about $24,000 in 1977 would result in enough additional income to cover expected expenditures in the near future and rebuild the reserve fund.

Mr. Chairman, the mechanisms set up under the Budget Reform Act of 1974 offer a real opportunity for intelligently coordinating tax expenditure policy with budget policy in the context to national priorities. All this, together with the commitment of Members of Congress and this committee means that there is now more than ever before a better chance to achieve real tax reform based on the principles of equity, progressivity and fairness. Toward that end we offer our help.

Thank you.

CAPITAL ACCUMULATION VERSUS CONSUMPTION

Senator MONDALE. Thank you very much. The previous witness argued that the tax preferences directed toward increased capital accumulation were poorly evaluated under the present system because the secondary effects, as they described them, are not calculated—and that while you might argue that these preferences deliver more tax advantages for the wealthy, as I understand their arguments, the preferences are reflected in increased capital investments which means more jobs, higher economic activity, et cetera. And the earlier witnesses argue that the present structure is unduly tilted toward consumption and that we have got to move toward savings so that the money is there for capital investments. How do you deal with these arguments?

TAX STRUCTURE PENALIZES INVESTMENTS

Mr. CANTOR. No. 1, I think we are just discovering and rediscovering and rehashing some real basic economic issues here as to whether, in the vernacular, it is trickle down or perculate up. The argument, as I understand it, presented by the National Association of Manufacturers is an assumption that our tax structure penalizes investment and therefore by penalizing investments you do not get the investments and productivity necessary. In terms of our present economic circumstances a key major issue is that there are over 7 million people unemployed and, according to official statistics from the Federal Reserve Board, industry is running at about 70 percent of its capacity. Under such circumstances, I cannot envision any kind of tax policy, particularly in the light of this committee's consideration for the upcoming budget year, that is going to really induce investments when there is so much excess capacity.

INCREASE PURCHASING POWER

At this stage of the game the most compelling issue is how are we going to increase purchasing power; how are we going to get the demands for goods and services. With that demand and with that purchasing power, in my eyes, will come business investments, business profits, cash flow, and productivity. We are in a very, very dangerous position in the recession cycle, and now is no time to undertake any kind of policies which would further hamper, either directly or indirectly, consumer spending and consumer purchasing power, by spending toward more incentives to business when they are operating at low capacity levels.

INVESTMENT TAX CREDIT

Senator MONDALE. I understood the AFL–CIO opposition to tax credit had softened.

Mr. CANTOR. No. Our opposition to the investment tax credit remains the same. The circumstances changed considerably in that, if the Senator recalls, a little over a year ago there was a meeting of the Labor Management Advisory Committee. This was very, very close upon the heels of the President's inflation message and the President's proposals to increase taxes. As members of the Labor Management Advisory Committee we were, quite frankly, scared stiff. We felt the economy was being pushed to the brink of a disaster. We felt that by going along with management, we could achieve our position for a much more equitable tax cut for low- and moderate-income people. As a result, management compromised and we compromised and we put together a package.

The real major goal there was to get something going to prevent the economy from going over the brink of disaster. We sought something that we could all agree on where we thought the President was going to go for a tax increase. Our official statement now on the investment credit is that as soon as the economic emergency is over, and we do not feel it is over yet, that this should be repealed.

Senator MONDALE. Mr. Young.

Mr. YOUNG. I just wanted to add. Senator, that the statement that was made earlier this morning about looking at secondary effects is one of those statements that I think everybody can agree with in generality, but when you start to look at the specifics and the results we'll have the greatest disagreements as to what the effects really are and I think the witnesses this morning indicated that. The problem is not whether or not to look at those secondary effects and to take account of them, but to really measure what they are and to really decide to what extent things like tax credits—the investment tax credit, in particular—really stimulate additional investment; to what extent the kind of proposal we heard this morning of giving people tax credit for saving money will really cause people to save more money than they are now saving. I think we can all agree that we ought to measure that but when we start to measure it we are going to come up with very different results as to what it means.

CONSUMPTION VERSUS CAPITAL ACCUMULATION

Senator MONDALE. Do you think our tax laws presently favor unwisely consumption versus capital accumulation?

Mr. YOUNG. I think that whether or not people save money, or whether people consume or invest, are much more affected by things like their current economic levels and their security of employment than the question of whether or not they will get a tax deduction for it.

CAPITAL ACCUMULATION AND THE ECONOMY

Senator MONDALE. Is it not also the case that capital accumulation has a lot to do with the condition of the economy? If we have full

employment we will be generating a lot more capital. As a matter of fact, improved as modestly as the economy is, I hear that profits this year are expected to rise quite drastically, and the percentage of general accumulated capital is now at very high levels. I sometimes get the idea that working Americans are being asked to pay three times—once through a stagnant economy which is reflected in high unemployment, et cetera, which they pay for, and then since the economy is stagnant and generating no revenues, through a cutback in social programs, and then through a cutback in tax revenue base to make up to one sector of the economy the cost of an unduly restrictive economic policy.

PAYROLL TAX

Just take this payroll tax that several of you mentioned. If we were at full employment we would not have to worry about that payroll tax. Over the long run, there would be some modest adjustments needed because of demographics. But the real problem is that instead of running a $13 billion trust fund surplus, which we would have at full employment, we are running a $3 billion annual deficit. So we are saying 8 million are unemployed, that is too bad, but more than that, for those of you who are working we have another $8 billion or $10 billion increased tax on working Americans. It is an unemployment tax which I think would discourage taking on new workers because it is an additional tax directed at the cost of employing people. Is that correct?

Mr. YOUNG. I think so, yes, sir. I think the other points are the kinds of things that a tax credit are spent for. We would not be assured they would really increase employment.

INVESTMENT TAX CREDIT

Senator MONDALE. Does the UAW favor the repeal of the investment tax credit?

Mr. YOUNG. Yes, sir.

Senator MONDALE. You do?

Mr. YOUNG. Yes, sir. We indicated at the time we supported the tax credit that it was for much the same reasons that Mr. Cantor said; that our support was in terms of dealing with an immediate problem. We had to get agreement on an overall tax cut. We clearly indicated that was intended to be just a temporary move and we are in favor of having the investment tax credit repealed.

Mr. BADE. I would like to point out, if I may, that I have indicated we would like it repealed. If there is need, that it would be by direct subsidy so we really know where the need is and it is directed at a labor-intensive industry rather than what is happening with a lot of the tax investment credits, that it becomes machine-intensive. Therefore many people are released in terms of the whole matter of development of efficiency in jobs and industry and all the rest. So we face the same problem, more people unemployed by the fact that there is an increase in the efficiency and the use of possibly more

machines. I am not against the use of technology but if we are looking at the whole matter of full employment we are faced by that kind of thing. So why not put it where we really know we need it and if at all possible put it in labor-intensive industries.

REVENUE GAINING TAX REFORM PROPOSALS

Senator MONDALE. There is one other question, about whether or not revenue gaining tax reform proposals should be made retroactive to January of this year. What is the alternative? January this year or January next year, do you have an opinion on that?

Mr. CANTOR. I think it is dependent on the type of provision you are discussing. The fact of the matter is that people pay withholding now and during the current year but the reconciliation does not have to take place until April 15. In the area of the present tax cut, which is slated to expire on June 30, action has to be taken to reconcile this issue. There are perhaps certain areas where there would be problems and other areas where there would not.

Senator MONDALE. Is there any other comment on that question?

Mr. YOUNG. There should not be any problem with the minimum tax area. On DISC or those areas the House has acted on on the floor, the corporations have all been alerted and I am sure they have set the funds aside.

Senator MONDALE. If you did something else there might be a retroactive problem because they have not been warned?

Mr. YOUNG. These are just looked upon as contingent liabilities at this moment.

Senator MONDALE. Are there any other observations? If not, thank you very much.

[Whereupon, at 11:35 a.m., the task force adjourned, to reconvene at the call of the Chair.]

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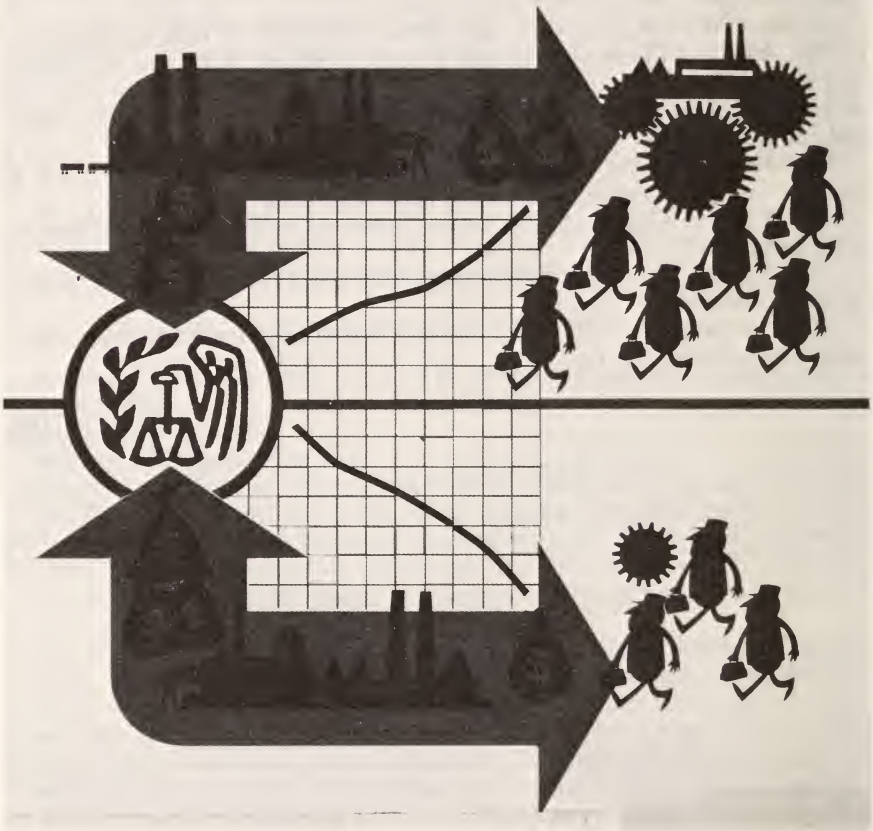
TAX IMPACT PROJECT REPORT



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SECOND PRINTING
August, 1975

Two sets of figures, which appeared in the first printing, have been deleted from this second printing. In the first printing, on pp. 1-9 in the columns labelled "5 YR CUM TOTAL" and on page iii, in the column labelled "Five Years Cumulative," there were figures for manufacturing employment and total employment which should be interpreted as cumulative man years gained or lost, not net changes in the number of job opportunities. To avoid possible confusion, this second printing has deleted all man year figures. In the tables on pp. 1-9 and page iii herein, the employment figures represent the estimated net changes in job opportunities through the end of each of the five years.

201-0675-87

June 16, 1975

The Committee on Taxation of the National Association of Manufacturers undertook this Tax Impact Project to begin developing a better method of estimating the overall economic consequences of proposed changes in federal taxation of business income. Because of the very close relationship between federal tax policy and economic activity, we believe that it is essential for major tax proposals to be considered in conjunction with objective analyses of their impact on capital investment, employment and the income tax base.

This report is one approach which we believe can be useful at the present time and stimulative of further development and refinement of the analysis of tax proposals in the future.

The project was developed by a special task force of committee members whose very considerable efforts have resulted in the preparation of this report. The task force was provided technical advice and assistance by Dr. Jerry E. Pohlman of Arthur Young and Company, New York, New York.

E. A. Vaughn
Chairman
Committee on Taxation

SUMMARY OF THE REPORT

This report describes a study of the impact on the economy which would be generated by each of seventeen proposals for changes in federal taxation of business income. Survey data were obtained from 313 diverse corporations representing 36% of total U. S. manufacturing sales. These data were used as input to a large macroeconomic computer model of the U. S. economy.

Every change in taxation of business income naturally would affect both corporate earnings and the entire economy in some way. The purpose of the Tax Impact Project is to focus on this relationship and to develop information which will be of use during the consideration of proposed modifications of the U. S. tax structure. The report presents the findings of the project in a manner which allows for comparisons of the economic impact of various proposals. The findings indicate that certain proposals are of major importance to the business community in allocating its resources in the most efficient manner.

Seventeen proposals for changes in federal taxation of business income were studied, and their overall domestic economic impact is described as changes in:

-- REAL FIXED INVESTMENT,
-- MANUFACTURING EMPLOYMENT,
-- TOTAL EMPLOYMENT,
-- REAL GNP, AND
-- NET FEDERAL TAX RECEIPTS.

It is recognized that the Tax Impact Project represents only one of a number of possible approaches to the economic analysis of tax proposals. As such, it is one step in the development of a reasonable method for obtaining such analyses. Thus, this report is intended to indicate the direction and the order of magnitude of the impact of the tax changes which were studied. In this regard, the econometric findings presented in this report should only be interpreted as somewhat imprecise estimates -- as are all estimates of what will in fact happen in the future.

The project is not simply a scale-up to the whole economy from the survey response data. Through use of a large macroeconomic model, it also takes into account a complex array of interactions and feedback effects between different parts of the economy, which are intended to simulate the real economic world. Such effects, of course, do not occur simultaneously. The findings are best interpreted as the likely economic consequences a few years after enactment of a tax proposal, i.e., after the effects of the proposed change would have had a chance to work their way throughout the national economy.

THE EFFECT ON TOTAL EMPLOYMENT FOR EACH OF THE SEVENTEEN PROPOSALS IS SHOWN IN THE FOLLOWING TABLE AND IS EXPRESSED AS THE DIFFERENCE FROM WHAT WOULD HAPPEN IN FUTURE YEARS WITHOUT THE TAX CHANGE. Results are presented in the body of the report for real fixed investment, manufacturing employment, real GNP, and net federal tax receipts.

TOTAL EMPLOYMENT EFFECTS

Proposed Change	After First Year	After Fifth Year
1. 10% Investment Credit	+ 80,000 jobs	+340,000 jobs
2. 40% ADR	+ 70,000	+260,000
3. Current CFC taxation with no foreign tax credit	-240,000	-790,000
4. Repeal of the investment credit	-120,000	-470,000
5. Repeal of the foreign tax credit	-110,000	-370,000
6. 50% corporate rate	- 60,000	-240,000
7. Current CFC taxation	- 60,000	-200,000
8. Repeal of ADR	- 50,000	-170,000
9. Multiple changes in the minimum tax	- 40,000	-160,000
10. Repeal of DISC	- 20,000	- 90,000
11. Repeal of tax deduction in minimum tax	- 10,000	- 50,000
12. 30% rate in minimum tax	- 10,000	- 50,000
13. Repeal of "possessions" treatment	- 10,000	- 50,000
14. Repeal of minimum distributions	- 10,000	- 20,000
15. Repeal of "per country" limitation	- 10,000	- 20,000
16. Repeal of WHTC	- 10,000	- 10,000
17. Repeal of LDCC exceptions	- 10,000	- 10,000

Significantly, the findings indicate that most of these proposed changes would reduce the level of total employment over a period of time.

****

A SHORT-TERM INCREASE IN FEDERAL TAX RECEIPTS IS, OF COURSE, EXPECTED IF BUSINESS TAXES ARE INCREASED. THE FINDINGS OF THIS STUDY, HOWEVER, SUGGEST THAT SUCH INCREASES ARE OBTAINED AT HIGH COST IN THE LONG TERM, THROUGH

1. REDUCED CAPITAL INVESTMENT,
2. REDUCED NUMBER OF JOBS FOR THE LABOR FORCE,
3. REDUCED GNP, AND ALSO, BECAUSE OF THESE ADVERSE CHANGES IN THE ECONOMY,
4. REDUCED FEDERAL TAX RECEIPTS IN THE FUTURE.

ON THE OTHER HAND, SIGNIFICANT DECREASES IN BUSINESS TAXES WILL GENERATE LONG-TERM BENEFICIAL EFFECTS ON INVESTMENT, EMPLOYMENT, THE ECONOMY AND FEDERAL TAX RECEIPTS.

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INTRODUCTION

The federal income tax plays a very significant role in the functioning of our economy, and changes in the tax system can have a very significant impact on the general health of our economy, particularly when those changes affect the industrial sector. Capital investments in new or modernized production facilities, which thereby create new employment opportunities and increase overall economic activity, are funded generally by capital consumption allowances, by retained earnings and by the amount of borrowed capital which such funds can support. To the extent that changes in tax law have a direct impact on the level of such earnings, they have an equally significant indirect impact on future levels of new investments, employment and total federal revenues. Thus, the overall economic impact of any proposed tax legislation will be much greater than can be indicated by an estimate of initial revenue gain or loss.

The project (TIP) used a survey of NAM members to measure the initial impact which specific tax proposals would have on tax liability. Coupled with the specific assumptions that changes in tax liability result in equal but opposite dollar changes in cash flow and that percentage changes in cash flow generate identical percentage changes in investments,these initial changes were applied to the overall economy through the Data Resources, Inc., (DRI) Long-Term Model of the U. S. Economy to determine how they would affect real fixed investment, employment, GNP and federal tax receipts over a period of years.

TIP REPRESENTS ONE METHOD OF ESTIMATING THE OVERALL ECONOMIC IMPACT OF TAX CHANGES. THE TIP FINDINGS ARE TO BE INTERPRETED AS INDICATIONS OF THE DIRECTION AND THE ORDER OF MAGNITUDE OF THE IMPACT OF EACH PROPOSAL, NOT AS PRECISE STATEMENTS REGARDING THE FUTURE EFFECTS OF SUCH PROPOSALS.

THE ECONOMIC EFFECTS OF EACH PROPOSAL, AS DERIVED BY THE ECONOMETRIC MODELING PROCESS, ARE EXPRESSED AS PERCENTAGE DIFFERENCES FROM WHAT WOULD HAPPEN IN THE U.S.IN FUTURE YEARS WITHOUT THE TAX CHANGE. AS SUCH, THEY DO NOT REPRESENT ABSOLUTE CHANGES FROM CURRENT LEVELS OF INVESTMENT, EMPLOYMENT, GNP AND TAX RECEIPTS.

For purposes of illustration, these percentages have been applied to 1977-1981 estimates of economic activity to produce dollar and job figures. Assuming enactment of any of these proposals in mid - 1975, this allows an eighteen-month interim as the period during which the impact of the change would be fully realized throughout the economy. (This does not assume that there will be no effects prior to 1977.)

NOTE: The percentages and the dollar amounts of changes in real fixed investment and real GNP are presented in terms of constant 1958 dollars whereas the percentages and dollar amounts with respect to federal tax receipts are net in terms of current dollars. The tables on pp. 1-9 are structured with the percentage change in each economic factor presented in the top row (%) and the dollar and job change in the bottom row (1958 $ billions, thousands of jobs, current $ billions).

FINDINGS OF THE PROJECT

The Tax Impact Project (TIP) has estimated the overall economic impact which would be generated by each of seventeen specific tax proposals affecting business income. The findings are presented below in three groups of tables -- Major Proposals Affecting Domestic Source Income, Major Proposals Affecting Foreign Source Income and Other Proposals. Explanations of the specific proposals are included in APPENDIX A. For a brief description of what the figures in the tables represent, see the INTRODUCTION on page vii.

Major Proposals Affecting Domestic Source Income

Of the seventeen proposals studied by TIP, the findings suggest that five which affect primarily domestic source income would have major impact on the domestic economy. Two of these would have long-term beneficial effects while three others would have adverse consequences.

The two beneficial proposals are enactment of a permanent 10% investment tax credit and of a 40% ADR. The TIP findings indicate that they would stimulate capital investment, thereby generating new employment opportunities throughout the economy. The resulting increase in business and personal taxable incomes would more than offset the initial reductions in tax liabilities.

The proposals with adverse consequences include repeal of the investment tax credit, repeal of ADR and an increase in the corporate tax rate. The TIP findings indicate that the long-term effects of each proposal would be to reduce the level of capital investments, thereby lowering the levels of employment which will otherwise develop. The resulting decrease in economic activity would lower taxable business and individual incomes, thereby more than offsetting estimates of initial revenue gains.

Table 1 -- 10% Investment Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	+3.06	+3.89	+3.85	+3.88	+4.05	+3.73	
(1958 $ billions)	+3.44	+4.77	+5.04	+5.36	+5.87		+24.48
Manuf. employment (%)	+ .90	+1.00	+ .92	+ .98	+1.01	+ .96	
(thousands of jobs)	+ 180	+ 210	+ 190	+ 210	+ 220		
Total employment (%)	+ .10	+ .24	+ .28	+ .33	+ .37	+ .27	
(thousands of jobs)	+ 80	+ 200	+ 250	+ 300	+ 340		
Real GNP (%)	+ .41	+ .51	+ .55	+ .62	+ .67	+ .56	
(1958 $ billions)	+3.82	+4.99	+5.63	+6.59	+7.38		+28.41
Federal tax receipts (%)	- .46	- .37	- .30	- .14	+ .05	- .24	
(current $ billions)	-1.83	-1.61	-1.42	- .72	+ .28		-5.30

Table 2 -- 40% ADR

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	+2.45	+2.99	+2.88	+2.90	+3.06	+2.86	
(1958 $ billions)	+2.75	+3.67	+3.77	+4.00	+4.44		+18.63
Manuf. employment (%)	+ .69	+ .76	+ .73	+ .76	+ .78	+ .74	
(thousands of jobs)	+ 140	+ 160	+ 150	+ 160	+ 170		
Total employment (%)	+ .09	+ .19	+ .20	+ .24	+ .28	+ .20	
(thousands of jobs)	+ 70	+ 160	+ 180	+ 220	+ 260		
Real GNP (%)	+ .41	+ .41	+ .43	+ .49	+ .54	+ .45	
(1958 $ billions)	+3.82	+4.01	+4.40	+5.21	+5.95		+23.39
Federal tax receipts (%)	- .35	- .28	- .23	- .11	+ .03	- .19	
(current $ billions)	-1.39	-1.22	-1.09	- .56	+ .17		- 4.09

Table 3 -- Repeal of the Investment Tax Credit

NOTE: This table assumes the existence of a 7% investment tax credit (4% for utilities). Similar results could be expected to occur if the credit (now 10% under P.L. 94-12) is repealed during the next several months. However, the magnitude of the impact could be expected to increase substantially if repeal is enacted when the new 10% rate is exercising its full effect.

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-4.17	-5.31	-5.25	-5.30	-5.54	-5.11	
(1958 $ billions)	-4.68	-6.52	-6.88	-7.32	-8.03		-33.43
Manuf. employment (%)	-1.25	-1.32	-1.25	-1.37	-1.45	-1.33	
(thousands of jobs)	- 250	- 270	- 260	- 290	- 310		
Total employment (%)	- .15	- .34	- .38	- .44	- .51	- .36	
(thousands of jobs)	- 120	- 290	- 330	- 390	- 470		
Real GNP (%)	- .58	- .70	- .74	- .85	- .95	- .81	
(1958 $ billions)	-5.40	-6.85	-7.58	-9.04	-10.46		-39.33
Federal tax receipts (%)	+ .62	+ .52	+ .43	+ .22	- .03	+ .35	
(current $ billions)	+2.46	+2.27	+2.04	+1.13	- .17		+ 7.73

Table 4 -- Repeal of ADR

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.63	-1.95	-1.88	-1.92	-2.03	-1.88	
(1958 $ billions)	-1.83	-2.39	-2.46	-2.65	-2.94		-12.27
Manuf. employment (%)	- .44	- .48	- .45	- .50	- .52	- .48	
(thousands of jobs)	- 90	- 100	- 90	- 100	- 110		
Total employment (%)	- .06	- .12	- .13	- .16	- .19	- .13	
(thousands of jobs)	- 50	- 100	- 110	- 140	- 170		
Real GNP (%)	- .26	- .26	- .28	- .33	- .37	- .30	
(1958 $ billions)	-2.42	-2.55	-2.87	-3.51	-4.07		-15.42
Federal tax receipts (%)	+ .23	+ .18	+ .12	- .01	- .02	+ .10	
(current $ billions)	+ .91	+ .78	+ .57	- .05	- .11		+ 2.10

Table 5 -- 50% Corporate Tax Rate

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.88	-2.25	-2.17	-2.21	-2.34	-2.17	
(1958 $ billions)	-2.11	-2.76	-2.84	-3.05	-3.39		-14.15
Manuf. employment (%)	- .53	- .57	- .54	- .58	- .62	- .57	
(thousands of jobs)	- 110	- 120	- 110	- 120	- 130		
Total employment (%)	- .07	- .14	- .15	- .18	- .22	- .15	
(thousands of jobs)	- 60	- 120	- 130	- 190	- 240		
Real GNP (%)	- .30	- .30	- .32	- .38	- .42	- .34	
(1958 $ billions)	-2.79	-2.94	-3.28	-4.04	-4.62		-17.67
Federal tax receipts (%)	+ .26	+ .23	+ .19	+ .10	- .18	+ .12	
(current $ billions)	+1.03	+1.00	+ .90	+ .51	-1.00		+ 2.44

Major Proposals Affecting Foreign Source Income

The TIP findings indicate that four of the proposals affecting foreign source income would have significant impact on the domestic economy.

NOTE: TIP has estimated the economic impact of changes in tax liability, assuming that the relationship between domestic investment and foreign investment will remain constant. While long-term adjustments in the ratio of domestic to foreign investment could be expected to follow major changes in taxation of foreign source income, it is beyond the scope or capacity of TIP to make assumptions in this regard. Therefore, Tables 6, 7 and 8 represent the estimates of the economic impact of these proposals, assuming that changes in levels of investment will be distributed between domestic and foreign uses in the same ratio as presently exists.

Table 6 -- Current Taxation of CFC Earnings

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- 1.91	-2.29	-2.20	-2.24	-2.38	-2.21	
(1958 $ billions)	- 2.14	-2.81	-2.88	-3.09	-3.45		-14.37
Manuf. employment (%)	- .54	- .58	- .54	- .60	- .63	- .58	
(thousands of jobs)	- 110	- 120	- 110	- 130	- 130		
Total employment (%)	- .07	- .14	- .15	- .19	- .22	- .15	
(thousands of jobs)	- 60	- 120	- 130	- 170	- 200		
Real GNP (%)	- .30	- .30	- .33	- .39	- .43	- .35	
(1958 $ billions)	- 2.79	-2.94	-3.38	-4.15	-4.73		-17.99
Federal tax receipts (%)	+ .27	+ .23	+ .19	+ .10	- .01	+ .16	
(current $ billions)	+1.07	+1.00	+ .90	+ .51	- .06		+ 3.42

Table 7 -- Repeal of the Foreign Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- 3.44	-4.08	-3.93	-4.00	-4.24	-3.94	
(1958 $ billions)	- 3.86	-5.01	-5.15	-5.52	-6.15		-25.69
Manuf. employment (%)	- .96	-1.02	- .96	-1.06	-1.12	-1.02	
(thousands of jobs)	- 190	- 210	- 200	- 220	- 240		
Total employment (%)	- .13	- .26	- .27	- .33	- .40	- .28	
(thousands of jobs)	- 110	- 220	- 240	- 300	- 370		
Real GNP (%)	- .55	- .54	- .58	- .69	- .76	- .62	
(1958 $ billions)	- 5.12	-5.29	-5.94	-7.34	-8.37		-32.06
Federal tax receipts (%)	+ .48	+ .41	+ .34	+ .17	- .02	+ .28	
(current $ billions)	+1.91	+1.79	+1.61	+ .87	- .11		+ 6.07

Table 8 -- Current Taxation of CFC Earnings coupled with Repeal of the Foreign Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- 7.55	- 8.88	- 8.53	- 8.58	- 9.07	- 8.52	
(1958 $ billions)	- 8.48	-10.90	-11.17	-11.85	-13.15		-55.45
Manuf. employment (%)	- 2.10	- 2.29	- 2.06	- 2.22	- 2.32	- 2.20	
(thousands of jobs)	- 420	- 470	- 430	- 470	- 490		
Total employment (%)	- .29	- .59	- .62	- .72	- .86	- .62	
(thousands of jobs)	- 240	- 500	- 540	- 650	- 790		
Real GNP (%)	- 1.20	- 1.24	- 1.24	- 1.47	- 1.61	- 1.35	
(1958 $ billions)	-11.18	-12.14	-12.70	-15.63	-17.73		-69.38
Federal tax receipts (%)	+ 1.03	+ .89	+ .70	+ .35	- .06	+ .58	
(current $ billions)	+ 4.09	+ 3.88	+ 3.32	+ 1.79	- .33		+12.75

Table 9 -- Repeal of DISC Provisions

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .82	- .98	- .94	- .96	- 1.02	- .94	
(1958 $ billions)	- .92	- 1.20	- 1.23	- 1.33	- 1.48		- 6.16
Manuf. employment (%)	- .23	- .25	- .24	- .26	- .27	- .25	
(thousands of jobs)	- 50	- 50	- 50	- 50	- 60		
Total employment (%)	- .03	- .06	- .06	- .08	- .10	- .06	
(thousands of jobs)	- 20	- 50	- 50	- 70	- 90		
Real GNP (%)	- .13	- .13	- .14	- .17	- .18	- .15	
(1958 $ billions)	- 1.21	- 1.27	- 1.43	- 1.81	- 1.98		- 7.7
Federal tax receipts (%)	+ .16	+ .10	+ .08	+ .04	- .01	+ .08	
(current $ billions)	+ .64	+ .44	+ .38	+ .21	- .06		+ 1.61

Other Proposals

The eight remaining proposals studied by TIP were found to have less substantial economic impact than the proposals discussed earlier, although the impact of a series of changes in the so-called minimum tax provisions would be rather significant, if enacted simultaneously.

Table 10 -- Changes in the Minimum Tax
(Increase the Rate to 30%)

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .39	- .48	- .46	- .47	- .50	- .46	
(1958 $ billions)	- .44	- .59	- .60	- .65	- .73		-3.01
Manuf. employment (%)	- .11	- .12	- .11	- .12	- .13	- .12	
(thousands of jobs)	- 20	- 20	- 20	- 30	- 30		
Total employment (%)	- .01	- .03	- .03	- .04	- .05	- .03	
(thousands of jobs)	- 10	- 30	- 30	- 40	- 50		
Real GNP (%)	- .06	- .06	- .07	- .08	- .09	- .07	
(1958 $ billions)	- .56	- .59	- .72	- .85	- .99		-3.71
Federal tax receipts (%)	+ .06	+ .04	+ .04	+ .02	- .01	+ .03	
(current $ billions)	+ .24	+ .17	+ .19	+ .10	- .05		+ .65

Table 11 -- Changes in the Minimum Tax
(Repeal of the Regular Income Tax Liability Deduction)

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .43	- .52	- .50	- .51	- .54	- .50	
(1958 $ billions)	- .48	- .64	- .66	- .70	- .78		-3.26
Manuf. employment (%)	- .12	- .13	- .12	- .13	- .14	- .13	
(thousands of jobs)	- 20	- 30	- 30	- 30	- 30		
Total employment (%)	- .01	- .03	- .04	- .04	- .05	- .04	
(thousands of jobs)	- 10	- 30	- 40	- 40	- 50		
Real GNP (%)	- .07	- .07	- .07	- .09	- .10	- .08	
(1958 $ billions)	- .65	- .69	- .72	- .96	-1.10		-4.12
Federal tax receipts (%)	+ .06	+ .05	+ .04	+ .02	- .01	+ .03	
(current $ billions)	+ .24	+ .22	+ .19	+ .10	- .05		+ .69

Table 12 -- Changes in the Minimum Tax
(30% Rate and Repeal of the Income Tax Deduction
coupled with Repeal of the $30,000 Exemption)

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	-1.45	-1.74	-1.68	-1.71	-1.81	-1.68	
(1958 $ billions)	-1.63	-2.13	-2.20	-2.36	-2.62		-10.94
Manuf. employment (%)	- .41	- .44	- .42	- .46	- .48	- .44	
(thousands of jobs)	- 80	- 90	- 90	- 100	- 100		
Total employment (%)	- .05	- .11	- .12	- .14	- .17	- .12	
(thousands of jobs)	- 40	- 90	- 100	- 130	- 160		
Real GNP (%)	- .23	- .23	- .24	- .29	- .32	- .26	
(1958 $ billions)	-2.14	-2.25	-2.46	-3.08	-3.52		-13.45
Federal tax receipts (%)	+ .19	+ .15	+ .12	+ .07	- .02	+ .10	
(current $ billions)	+ .76	+ .65	+ .57	+ .36	- .11		+ 2.23

Table 13 -- Repeal of "Possessions Income" Treatment

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .39	- .47	- .45	- .46	- .49	- .45	
(1958 $ billions)	- .44	- .58	- .59	- .64	- .71		-2.96
Manuf. employment (%)	- .11	- .12	- .11	- .12	- .13	- .12	
(thousands of jobs)	- 20	- 20	- 20	- 30	- 30		
Total employment (%)	- .01	- .03	- .03	- .04	- .05	- .03	
(thousands of jobs)	- 10	- 30	- 30	- 40	- 50		
Real GNP (%)	- .06	- .06	- .07	- .08	- .09	- .07	
(1958 $ billions)	- .56	- .59	- .72	- .85	- .77		-3.49
Federal tax receipts (%)	+ .05	+ .05	+ .03	+ .02	- .01	+ .03	
(current $ billions)	+ .20	+ .22	+ .14	+ .10	- .05		+ .59

Table 14 -- Repeal of "Minimum Distributions"

NOTE: Table 14 presents figures with respect to repeal of the "minimum distributions" provisions, an action taken by the Tax Reduction Act of 1975 (P. L. 94-12), effective January 1, 1976.

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .19	- .22	- .22	- .22	- .24	- .22	
(1958 $ billions)	- .21	- .27	- .29	- .30	- .35		-1.42
Manuf. employment (%)	- .06	- .06	- .06	- .06	- .06	- .06	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		
Total employment (%)	- .01	- .01	- .01	- .02	- .02	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 20	- 20		
Real GNP (%)	- .03	- .03	- .03	- .04	- .04	- .03	
(1958 $ billions)	- .28	- .29	- .31	- .43	- .44		-1.75
Federal tax receipts (%)	+ .03	+ .02	+ .02	+ .01	- .01	+ .02	
(current $ billions)	+ .12	+ .09	+ .09	+ .05	- .06		+ .29

Table 15 -- Repeal of the "Per Country" Limitation on the Foreign Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .15	- .18	- .18	- .18	- .19	- .18	
(1958 $ billions)	- .17	- .22	- .24	- .25	- .28		-1.16
Manuf. employment (%)	- .04	- .05	- .04	- .05	- .05	- .05	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		
Total employment (%)	- .01	- .01	- .01	- .01	- .02	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 20		
Real GNP (%)	- .02	- .02	- .03	- .03	- .03	- .03	
(1958 $ billions)	- .19	- .20	- .31	- .32	- .33		-1.35
Federal tax receipts (%)	+ .02	+ .02	+ .01	- .01	- .01	+ .01	
(current $ billions)	+ .08	+ .09	+ .05	- .05	- .06		+ .11

Table 16 -- Repeal of the Western Hemisphere Trade Corporation (WHTC) Provisions

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .12	- .14	- .14	- .14	- .15	- .14	
(1958 $ billions)	- .13	- .17	- .18	- .19	- .22		- .89
Manuf. employment (%)	- .04	- .04	- .04	- .04	- .04	- .04	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		
Total employment (%)	- .01	- .01	- .01	- .01	- .01	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		
Real GNP (%)	- .02	- .02	- .02	- .02	- .03	- .02	
(1958 $ billions)	- .19	- .20	- .20	- .21	- .33		-1.13
Federal tax receipts (%)	+ .02	+ .01	+ .01	+ .01	- .01	+ .01	
(current $ billions)	+ .08	+ .04	+ .05	+ .05	- .05		+ .17

Table 17 -- Repeal of the Less Developed Country Corporation (LDCC) Provisions

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	- .08	- .10	- .09	- .10	- .10	- .09	
(1958 $ billions)	- .09	- .12	- .12	- .14	- .15		- .62
Manuf. employment (%)	- .02	- .02	- .02	- .02	- .02	- .02	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		
Total employment (%)	- .01	- .01	- .01	- .01	- .01	- .01	
(thousands of jobs)	- 10	- 10	- 10	- 10	- 10		
Real GNP (%)	- .01	- .01	- .01	- .02	- .02	- .01	
(1958 $ billions)	- .09	- .10	- .10	- .21	- .22		- .72
Federal tax receipts (%)	+ .01	+ .01	+ .01	- .01	- .01	+ .01	
(current $ billions)	+ .04	+ .04	+ .05	- .05	- .05		+ .03

WHY A TAX IMPACT PROJECT?

The Tax Impact Project (TIP) was undertaken with three general objectives in mind. They were:

-- to begin the development of a method of estimating the overall economic impact of business-related tax proposals in general;

-- to develop economic impact estimates for specific proposals which might arise in 1975; and

-- to lay the groundwork for the possible development of a continuing project which could assess very rapidly the economic impact of any major tax proposal.

Considering the magnitude of the federal income tax structure, its intertwining with the economy and the massive capital needs of the future, it is increasingly important that the economic consequences of proposed tax legislation be studied thoroughly. TIP was conceived as a vital step in developing a capability to estimate in advance the effects which tax proposals would have on real capital investment, employment opportunities, real GNP and federal tax revenues over a period of years.

TIP is not represented to be the last word in economic analysis of tax proposals. It is one step in the development of methods of obtaining such analyses. It is intended to aid the illustration of the relationship between tax policy and economic activity and how this relationship is important to business and labor, to producers and consumers, to the private sector and the government, indeed to all facets of the economy. In so doing, it is hoped that TIP will help to raise the debates over federal tax policy from the level of political and emotional harangues to a rational discussion of the economic impact of tax legislation. In addition, it is hoped that TIP will lead to additional development and refinement of economic impact studies of tax proposals.

The Income Tax in Our Economy

The existing Internal Revenue Code -- all 37 chapters plus thousands of pages of Treasury Regulations -- has evolved from a very simple and uncomplicated ancestor. Following ratification of the Sixteenth Amendment, the federal income tax was enacted in 1913 as what appears, on the surface, to have been a minor afterthought in a major tariff act. Most individuals fell within the 1% rate bracket on taxable incomes of up to $20,000, with relatively few affected by the graduation of rates up to a maximum of 6% at the $500,000 income level. Corporations were subject to a 1% tax rate on their incomes. As a source of federal funds, the income tax provided only 5% of federal net revenues in 1913.

During the past sixty years, the income tax system has grown considerably in size and in importance. For fiscal year 1974, the income tax on individuals and corporations provided $157.6 billion in federal revenues, approximately 75% of all federal budget receipts, excluding Social Security taxes on employers and employees. The individual rate structure now ranges from a minimum of 14% to a maximum of 70% on unearned income, approximately twelve times the comparable 1913 rates. The maximum rate is now 48% on corporate income, making the federal government virtually the equivalent of a 50% shareholder in this country's largest business enterprises.

The Relationship Between Tax Policy and Economic Activity

Thus, the federal income tax now plays a very significant role in the functioning of our economy. Business and consumers alike make expenditure plans based on many factors -- fixed expenses, prices, availability of goods and services, essentials versus luxury items, hopes and fears about the future. Yet, in the final analysis, it is the availability of money which determines how far down the shopping list they can go. In this day and age, that means after-tax dollars, because to the extent that the federal income tax consumes taxpayer dollars, it reduces the funds available for private sector activity.

This is particularly true of new capital expenditures by business. Investment in new physical plants and productive equipment or in modernization of existing facilities has an impact far beyond merely creating new employment opportunities within the investing companies themselves. Capital expenditures directly create employment and incomes for construction workers who build and modernize factories, for production workers who manufacture the construction materials and the equipment for the new and modernized facilities, for service workers who transport and maintain the new equipment, for administrative personnel who handle transactions and production schedules and for many other related workers. The effects of capital expenditures also are felt as the businesses and individuals who are paid for their goods and services spend their incomes. The spending and re-spending of the invested dollars generate a higher level of economic activity than would otherwise be the case. As business and individual incomes rise, one additional beneficiary is the federal government which realizes increased tax revenues.

The relationship between tax policy and business investments is particularly close. While many factors affect capital expenditure plans, the availability of funds is of primary importance. Corporate cash flow (capital consumption allowances and retained earnings) plays a primary role in such planning. Not only is cash flow a source of capital itself, it also has a substantial impact on the amount of borrowed capital which a business can obtain. Thus, when changes in tax policy affect the volume of a company's cash flow, the effect on available capital can be larger than the initial change in tax liability itself.

The overall impact of major tax legislation is illustrated readily by the economic history of the investment tax credit. The credit has a direct impact on the capital expenditures of industry by increasing the internal funds available for such expenditures. Following enactment of the credit in 1962, new orders for machinery and equipment increased steadily, along with employment in capital goods industries and with corporate tax revenues. The 1966-1967 suspension period witnessed a leveling off or decline in these areas. From 1967 through the 1969 repeal, new orders for capital goods, employment and corporate tax revenues rose steadily. Following the repeal, the real decline was very significant. Reinstatement of the credit and enactment of ADR in 1971 were followed by renewed growth in these areas.

Unfortunately, general awareness of the potential economic impact of tax changes is fleeting. While it is easy to comprehend how a tax rebate or a general reduction of individual rates will favorably affect one's personal spending and investment plans, it is more difficult to understand how this effect can be multiplied thousands and millions of times across the country and how the resulting increase in economic activity can benefit the country as a whole, particularly through the business sector. And yet, the family-owned small business and the billion dollar

manufacturing corporation are affected in the same general ways by changes in tax liability; only the magnitude of the impact is different.

The Need for More Comprehensive Information

One specific function which the project will perform is to provide a more comprehensive means of measuring the federal revenue impact of tax proposals. The existing procedure for estimating revenue impacts of tax proposals is rather firmly established. It involves estimating the change in tax liabilities based on expected levels of income in areas affected by a proposal. As a means of comparing the initial impact of various proposals, this can be a useful procedure. As a means of estimating what will actually happen to federal revenues, such a procedure stops well short of a complete assessment of the impact of a specific proposal. In considering only the initial impact of a proposal, it assumes that no compensating actions are taken by the taxpayer.

With respect to changes in taxation of business income, TIP considers the secondary or "feedback" effects of tax proposals. As cash flow is reduced, business investments will be altered, employment levels will be affected, dividends may be changed and price structures may be subject to review. Multiplying these changes by the thousands of companies and the millions of individuals affected indicates the magnitude of the "feedback" effects which tax proposals can generate. Thus, TIP builds on the initial impact figures in estimating the long-term net changes in federal tax receipts presented in the tables.

Selection of the Econometric Approach

Studying the feedback effects of tax proposals is a complex task. To determine the overall changes in investment, jobs, GNP and federal revenues, the project required the use of a well developed econometric computer model to take into account the hundreds of equations which simulate actual relationships within the economy.

An established and well recognized econometric model was chosen for the purpose of generating the type of information sought by the project. A survey was constructed to collect the data to be used as input into the model. None of the assumptions or structural relationships within the model were altered.

With the Congress expected to consider a number of major tax proposals in 1975, the study covered by this report was undertaken both to test the methodology and to generate information with respect to a number of perennial tax proposals, including changes in the investment tax credit, ADR, corporate tax rates and foreign source income treatment. Thus, the first TIP results are expected to be of practical usefulness, not just of academic interest.

A possible long-term application of TIP is the development of a capability to analyze any major tax proposal without time consuming surveys. The first study has been structured to allow such development, should that be judged desirable.

METHODOLOGY OF THE PROJECT

The Survey

In order to utilize the econometric model, it was necessary to gather data regarding the initial impact of the tax proposals on the tax liabilities and capital investments of industrial taxpayers. This was accomplished through a survey of NAM member companies.

The survey form asked that a responding company indicate the dollar amount by which its tax liability for its most recent taxable year would have been increased or decreased if each of seventeen specific tax proposals had been in effect during that year. In addition, the firm was asked to provide information about its retained earnings for the year.

All of these figures were included in calculations to determine the percent by which government tax receipts and total investment in fixed assets would be changed by each particular tax proposal. The percent changes were then used as input for the model in order to calculate the domestic economic effects of the proposals.

The survey was mailed to 1050 of the largest NAM member companies in November 1974. The list of recipients was compiled by selecting the fifty largest member firms (by sales volume) in each of the manufacturing Standard Industrial Classification (SIC) Codes from 20 through 39, plus utility SIC Code 49. (See APPENDIX B for list of industries by SIC Codes.) The cover letter explained the purpose of the survey and asked for cooperation with the understanding that the responses would be collected and compiled in complete confidentiality. The only figures to be released would be the econometric results.

From the 1050 largest companies, 313 responses were received and used in compiling the percentage changes in tax receipts and investments used as inputs for the model. Over sixty percent of the responses were based on calendar 1973. Approximately twenty percent were for fiscal 1974. At the time of the survey, this was the most recently available information.

The responding companies represent all major industries in the U.S., and they represent substantial portions of all sales and investments by U.S. industrial companies. Responses to the survey came from companies in the various manufacturing industries and in the electric and gas utility industries. The responses represent approximately 35% of the companies on the Fortune 500 Largest Industrial Companies list. Total sales of the responding manufacturers represented 36% of total sales of all U.S. manufacturers. Responding Fortune 500 members accounted for approximately 95% of the total sales volume of responding companies. All Fortune 500 sales represent approximately 80% of all manufacturing sales. The responding manufacturers accounted for approximately 35% of all new investment in domestic plant and equipment.

For a detailed discussion of the survey and preparation of the model input, see APPENDIX C.

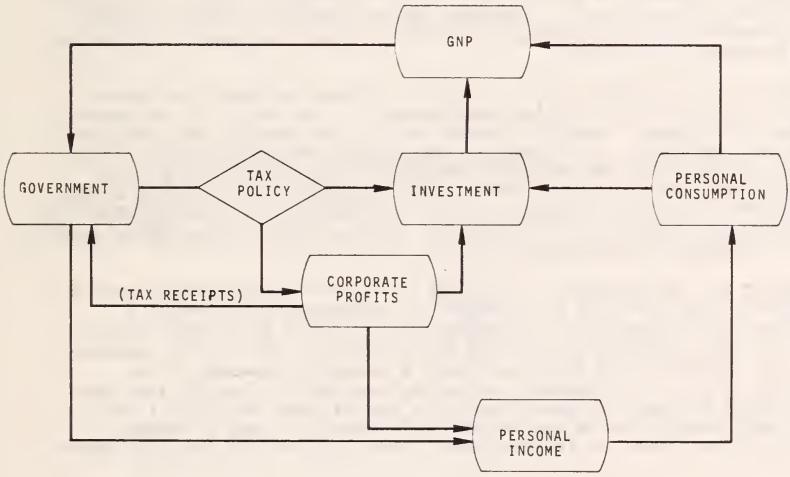
The Econometric Model

Workings of the model. An econometric model of the economy is a series of functional relationships tying the various sectors of the economy together into a unified system. A model is designed to measure mathematically and statistically these relationships among numerous economic variables. Such models are useful in analyzing specific elements of economic activity, as well as for tracing the complex feedback and interrelationships within the total economy.

Basically, a model consists of a number of simultaneous equations, each of which describes a certain functional relationship within the economic system. The number of equations in a model will vary depending upon the scope of the model. TIP used the Data Resources, Inc., (DRI) Long-Term Model of the U. S. Economy, which consists of over 900 equations which identify and measure the interrelationship among all major sectors of the economy.

The following diagram (CHART 1) is a simplified version of how an econometric model ties the economy into a self-contained whole and feeds data from one sector into another. This diagram is highly simplified and is designed to highlight the sectoral relationships important to the project. Thus, the other elements of the economy that are affected by the variables in the diagram are not represented.

CHART I: MACROECONOMIC MODEL



Each box represents a major element of the economy. The lines connecting the boxes indicate how elements from one sector are utilized to determine the other elements. The circular nature of the diagram reflects "flow" of economic activity and the simultaneous nature of the system. Thus, the model captures the "circular" nature of economic activity.

Gross national product (GNP) is the measure of total output of goods and services in the economy. Government tax policy, in addition to being a source of revenue, influences economic activity (GNP) by either stimulating or restricting economic growth. Thus, in this simplified diagram, tax policy is seen as influencing investment directly, as well as indirectly through corporate profits. At the same time, the level of GNP affects government in terms of tax receipts, as shown by the connecting boxes. Thus, government tax policy can either stimulate or deter investment spending on new equipment.

Other factors affecting investment spending shown by the diagram are the level of consumer expenditures and the level of corporate profits, which in turn is affected by government tax policy. Consumer expenditures are a factor in determining whether additional investment in equipment is necessary to satisfy demand. In turn, the level of expenditures by consumers is affected by the gain (or loss) in personal income resulting from changes in output and employment. Also, corporate profits and government programs are determinants of the gain or loss in personal income, which will then affect the level of spending that dictates the amount of additional investment necessary to meet demand, and so on. The variables in the diagram illustrate this cause and effect feedback of the economic system.

Many other variables, of course, play a part in determining each of the elements illustrated by the diagram. The purpose of this particular diagram is simply to delineate the crucial connections among tax policy, investment, total output, and government tax receipts.

Once built, a macroeconomic model is able to estimate the impact on hundreds of economic relationships resulting from changes in the parameters of the economic system. The impact of specific changes, such as alterations in tax policy and investment decisions, can be analyzed under varying sets of assumptions. Such models not only allow for the complex feedback of large numbers of economic forces, they also make feasible the analysis of extremely large amounts of data. Therefore, in addition to theoretical considerations, it was useful to adopt an econometric approach for TIP because of the exceptionally large body of data which the project incorporates.

Inputting the survey results. In order to obtain general macroeconomic results from the initial effect of a tax proposal as determined by the survey, a long-term macroeconomic model was chosen. If a model of the current economy had been used, the results would have been distorted by the existing recession. As a result, the figures would not provide a reasonable statement of the economic impact of the proposals over a long-term period. Further, since the majority of the survey responses were based upon calendar year 1973, it would have been inappropriate to use the results in a model of today's economy. Therefore, the survey results were used as input into the long-term model which

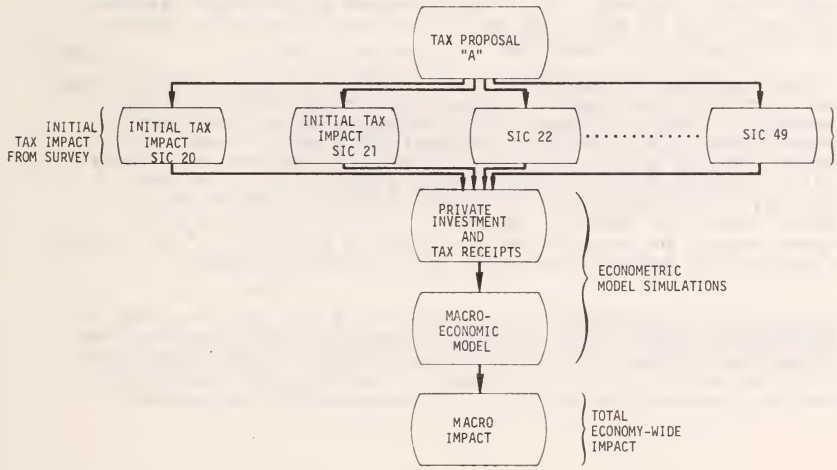
assumes that the economy is at or near its long-term growth path. If the tax changes were adopted in a recession, the effects would be somewhat altered.

While 1973 was not a normal year in many respects, industrial utilization, economic growth, and the level of unemployment were close to generally considered long-term full employment growth levels and consistent with the assumptions of the long-term model that was used. Inflation increased dramatically throughout 1973 and was at rates quite above the assumptions of the model. However, since the results of the survey were interpreted in real terms, much of this bias was eliminated.

The survey data on each change in tax liability were compiled by SIC code. It was assumed that such changes in tax liability result in equal dollar changes in corporate cash flow. Also, a constant ratio of total investment to cash flow was assumed for determining the initial impact of a change in cash flow on investment. Once the feedback mechanism of the interrelationships within the economy is felt, however, the process becomes much more complex. While the initial impact on investment is determined by the change in cash flow, the subsequent impact is determined by changes in demand, the movement of interest rates, the cost of capital, the change in dividend payments and other factors. (See APPENDIX C, pp. 31-32 for a fuller discussion.)

Once the change in investment was determined in each SIC code, these changes were weighted to represent the relative importance of investment in that SIC code to total investment in the economy. Then the initial changes in tax liabilities and investment in each industry flowed into the macroeconomic model (see CHART 2) where the feedback effects began to work. The changes ripple throughout various sectors of the economy (see CHART 1 on p. 14) and the macroeconomic impact is determined.

CHART 2: TAX IMPACT PROJECT MODEL



NOTE: It was assumed that the existing ratio between domestic and foreign investment will remain the same after any tax change. The findings represent only the changes which would occur in the domestic economy based on the existing relationship. While long-term adjustments to foreign investments could be expected to follow significant changes in tax treatment of foreign source income, it is beyond the scope or capacity of the project to make assumptions in this regard.

The results. The table on page 18 illustrates the format in which all of the TIP findings are presented in this report in pp. 1-9. The results are in terms of fixed investment, manufacturing employment, total employment, GNP and federal tax receipts for the simulation period. These have been selected as the economic factors which best illustrate the overall impact of each tax proposal. It should be noted that changes in GNP and fixed investment are based on constant (1958) dollars while federal government tax receipts are based on current dollars. The reason for this difference is to show GNP and fixed investment without distortion due to inflation while federal government tax receipts are depicted in actual dollars received. Thus, the numbers cannot be analyzed in terms of each other without first "deflating" government tax receipts.

The tables present the economy-wide effects of each tax proposal, both on a percentage change basis (the rows of figures designated (%)) and on a dollar and jobs basis (the rows of figures designated ($) and (jobs)). The percentage change reflects the change in the total economy as a result of the tax proposal as compared to economic conditions in the absence of any tax change. Note that these are differences from what otherwise would occur. The percentages are not intended to represent absolute changes from conditions in 1975.

The percentage effect of each of the tax proposals on the total economy is shown on an annual basis over a five-year period. It is assumed that the tax change remains in effect during the entire five-year period of the study. It is also assumed that the proposal has been in place for a period of approximately 18 months so that its full impact is realized. To translate the percentage changes into real figures, the percentages were applied to the long-term growth model of the U.S. economy. The differences between the basic model (assuming no changes due to tax policy) and the new simulations (based on the impact of the tax proposals) were calculated.

It should be noted that the multiple impact of all of the various feedbacks from the interrelationships within the economic system produce different results depending upon the time framework. For example, manufacturing employment is generally impacted more than total employment during the first year of full impact. This, of course, is what one would expect as employees are initially pulled into manufacturing from other sectors when the effect is positive or find jobs in other sectors when the effect is negative. After the "first round," however, the impact on investment is felt in other sectors of the economy as well, and output and employment react in these areas. Thus, the later effects on total employment are greater than in manufacturing alone.

For purposes of illustration, the five-year period of 1977-1981 was selected to illustrate the effects of the seventeen TIP proposals. This assumes that these proposals were adopted in mid - 1975 and that an eighteen month interim period will allow the full effect of the change to be realized. This assumption was made for illustrative purposes only. It is recognized that the appropriate

periods for any given proposals can vary widely. It should be noted that TIP does not assume that there will be no impact in 1975 or 1976, merely that the full effect is assumed to be reached beginning in 1977.

It should also be noted that the TIP findings were based on tax law prior to P.L. 94-12. Therefore, the findings have been calculated by a model which did not take into account a 10% investment tax credit, except with respect to that specific proposal.

Table I -- 10% Investment Tax Credit

	YR 1	YR 2	YR 3	YR 4	YR 5	ANNUAL AVG %	5 YR CUM TOTAL
Real fixed investment (%)	+3.06	+3.89	+3.85	+3.88	+4.05	+3.73	
(1958 $ billions)	+3.44	+4.77	+5.04	+5.36	+5.87		+24.48
Manuf. employment (%)	+ .90	+1.00	+ .92	+ .98	+1.01	+ .96	
(thousands of jobs)	+ 180	+ 210	+ 190	+ 210	+ 220		
Total employment (%)	+ .10	+ .24	+ .28	+ .33	+ .37	+ .27	
(thousands of jobs)	+ 80	+ 200	+ 250	+ 300	+ 340		
Real GNP (%)	+ .41	+ .51	+ .55	+ .62	+ .67	+ .56	
(1958 $ billions)	+3.82	+4.99	+5.63	+6.59	+7.38		+28.41
Federal tax receipts (%)	- .46	- .37	- .30	- .14	+ .05	- .24	
(current $ billions)	-1.83	-1.61	-1.42	- .72	+ .28		- 5.30

Example: Assuming enactment of a 10% investment tax credit, the percentage change in manufacturing employment in the first year, due to the tax impact, would mean + 180,000 jobs for that year. The average yearly change in manufacturing employment would be +.96% which, in terms of the model simulations for 1977 to 1981, would result in a net addition of + 220,000 jobs in manufacturing employment after five years.

APPENDIX A: DESCRIPTIONS OF THE TAX PROPOSALS

The Tax Impact Project Report discusses the economic impact of 17 specific tax proposals. These proposals are described below in the order in which they are presented in the report.

Major Proposals Affecting Domestic Source Income

10% Investment Tax Credit (p.1)

The investment tax credit for qualified section 38 property has been raised to 10% across the board during 1975-1976 for all taxpayers, including utilities, by P.L. 94-12, the Tax Reduction Act of 1975. At the time of the TIP survey in 1974, the investment tax credit rate was 7% generally, 4% for utilities. The TIP results represent the effects which the higher rate alone will have, assuming that it is made permanent. This assumes no other changes in credit rules, such as the 50% tax liability limitation, the 3-5-7 rule or any other credit-related provisions. The 10% rate would apply to all qualified property placed in service during the taxable year covered by the survey and to the basis of qualified property attributable to construction, reconstruction or erection during such taxable year.

40% ADR (p. 2)

Under existing law, the Asset Depreciation Range (ADR) allows a 20% variance from the asset guideline period (depreciable life) established for property within each asset guideline class. This allows the taxpayer to select a depreciation period which is up to 20% shorter (or longer) than the guideline period. The proposal would increase the allowable variance to 40%. No changes in the guideline periods or in any other ADR-related provisions would occur. The 40% variance would be applicable beginning with assets on which depreciation began during the taxable year covered by the survey.

Repeal of the Investment Tax Credit (p. 2)

At the time of the TIP survey in 1974, the investment tax credit rate was 7% generally, 4% for utilities. Therefore, the proposal contemplates repeal of a 7% credit as it existed prior to enactment of the 10% rate in P.L. 94-12, the Tax Reduction Act of 1975. Repeal would be effective on the first day of the taxable year covered by the survey. Thus, the TIP results assume that the taxpayer could not have taken any investment tax credit for that year.

Repeal of ADR (p. 3)

The Asset Depreciation Range (ADR), which allows a 20% variance from the asset guideline period (depreciable life) for each class of depreciable property, would be repealed, effective as of the first day of the taxable year covered by the survey. Depreciation deductions would be based on the full guideline lives as established in Treasury Regulations for all property on which depreciation began during that year.

50% Corporate Tax Rate (p. 3)

At the time of the TIP survey in 1974, the corporate tax rate was composed of a 22% normal tax on all corporate income and a 26% surtax on all corporate income in excess of $25,000, creating a 48% tax rate on income above $25,000. The proposal would increase the surtax rate to 28%, thereby creating a 50% rate. This 50% rate would be effective for the taxable year covered by the survey. The TIP results do not take into account certain provisions of P.L. 94-12 which altered the normal tax and the corporate surtax exemption.

Major Proposals Affecting Foreign Source Income

Current Taxation of CFC Earnings (p. 4)

Under existing law, the earnings of foreign subsidiaries of U.S. companies, often called controlled foreign corporations or CFC's, generally are taxable by the United States only when paid as dividends to domestic parents or other domestic shareholders. The only exceptions are found in Subpart F (sections 951-964) which was enacted to reach so-called "tax haven" income.

Under the proposal, 100% of the annual earnings of CFC's (any foreign corporations which are more than 50% controlled by U.S. persons) would be deemed paid as dividends in the year earned without regard to whether they are in fact distributed. The U.S. shareholders would be taxable on their pro rata share of such earnings. The foreign tax credit would remain intact and would be available with respect to such deemed-paid dividends. This proposal would be in effect for CFC earnings during the taxable year covered by the survey, but not for previously accumulated earnings.

Repeal of the Foreign Tax Credit (p. 4)

Under existing law, U.S. persons who have foreign source income must include it in gross income and pay U.S. income tax thereon. If that income has also been subject to income, war profits or excess profits taxes in foreign countries, the taxpayer may credit such taxes against the U.S. tax due on the same income, subject to certain computation rules. (Foreign taxes may not be credited against federal taxes due on U.S. source income.) This credit is available both for taxes paid directly by the U.S. taxpayer and for taxes paid by various levels of foreign subsidiaries and then deemed paid by the U.S. taxpayer.

Under the proposal, the credit would be completely repealed. Foreign taxes would be allowed only as a business deduction in computing taxable income. This would be effective with respect to all foreign taxes which would otherwise be creditable during the taxable year covered by the survey. This proposal would not require current taxation of 100% of CFC earnings.

Current Taxation of CFC Earnings coupled with Repeal of the Foreign Tax Credit (p. 5)

Under this proposal, the current taxation of CFC earnings and repeal of the foreign tax credit, as described above, would occur simultaneously. All subsidiary earnings would be taxable directly to U.S. shareholders and foreign taxes could be taken only as a deduction, not as a credit. This would be effective for CFC earnings and foreign taxes thereon during the taxable year covered by the

survey, but not for previously accumulated CFC earnings.

Repeal of DISC Provisions (p. 5)

At the time of the TIP survey in 1974, Domestic International Sales Corporation (DISC) treatment was available to domestic corporations engaged in exporting all types of domestic products, minerals and foodstuffs. P.L. 94-12, the Tax Reduction Act of 1975, restricted somewhat the list of qualified export items. A DISC is a separate, non-taxable corporation which receives 95% of its receipts from export business. Tax on 50% of its income is deferred until distributed while 50% is taxable to its shareholders, usually a parent company, in the year earned. Income attributable to export receipts is treated as foreign source income by the parent and receives separate treatment for foreign tax credit purposes. The DISC may loan its deferred income to the parent for export-related uses. This proposal would repeal DISC treatment effective for all income during the taxable year covered by the survey, but not for previously tax-deferred DISC income.

Other Proposals

Changes in the Minimum Tax (pp. 6-7)

Under current law, a corporation is subject to an additional tax (also known as the minimum tax) on the total of "tax preference" items which it uses. These items include capital gains, accelerated depreciation on real property, special amortizations and percentage depletion. The total of "tax preferences" is reduced by a $30,000 exemption and by the amount of regular income tax liability (minus tax credits). The remaining amount of "tax preference" income is subject to a 10% tax.

The various proposals considered by TIP would (1) increase the tax rate to 30%, (2) repeal the regular income tax liability deduction, and (3) enact these simultaneously with a repeal of the $30,000 exemption. These proposals would be effective for the taxable year covered by the survey.

Repeal of "Possessions Income" Treatment (p. 7)

Under current law, a U.S. corporation which derives 80% of its gross income from U.S. possessions (including Puerto Rico and Guam but excluding the Virgin Islands) and 50% of its gross income from active conduct of a trade or business in such possessions, may exclude from gross income all income from such possessions and from foreign sources. The proposal would repeal this treatment effective for all possessions income and foreign source income earned or received during the taxable year covered by the survey, but not for previously excluded income.

Repeal of "Minimum Distributions (p. 8)

At the time of the TIP survey in 1974, section 963 of the Code provided a "minimum distributions" mechanism through which U.S. taxpayers, who otherwise would be subject to the special Subpart F treatment of so-called "tax haven" income, could be relieved of the administrative and accounting burdens of Subpart F. Under this concept, taxpayers could exclude from gross income all

Subpart F income if their worldwide income was taxable at 90% of the maximum U.S. rate, or 43%. The schedule in section 963 provided the minimum percentage of foreign income which had to be distributed to U.S. shareholders to raise the effective worldwide rate to 43%.

P.L. 94-12, the Tax Reduction Act of 1975, repealed "minimum distributions" effective January 1, 1976. The TIP results are based on such a complete repeal in the taxable year covered by the survey.

Repeal of the "Per Country" Limitation on the Foreign Tax Credit (p. 8)

Prior to P.L. 94-12, the Tax Reduction Act of 1974, there were two methods of computing the maximum foreign tax credit--the "per country" limitation and the "overall" limitation. Under the "per country" limitation, the foreign tax credit is computed with respect to the taxes paid on income from each foreign country. The maximum credit which can be taken against U.S. taxes on Country X source income is computed by multiplying tentative U.S. tax liability times the ratio of Country X source taxable income to worldwide taxable income. This is repeated for income from each foreign country. Under the overall limitation, the maximum credit is computed by multiplying tentative U.S. tax liability times the ratio of all foreign source taxable income to worldwide taxable income.

P.L. 94-12 repealed the "per country" limitation with respect to foreign oil-related income. The TIP proposal would repeal the "per country" limitation altogether for all foreign source income during the taxable year covered by the survey.

Repeal of Western Hemisphere Trade Corporation (WHTC) Provisions (p. 9)

Under current law, a U.S. corporation, which (1) does all of its business in the Western Hemisphere, (2) receives 95% or more of its gross income from non-U.S. sources, and (3) receives 90% or more of its gross income from the active conduct of a trade or business, receives a special deduction from taxable income as otherwise computed. The effect is to reduce the maximum 48% corporate rate by 14 percentage points, down to 34%. This proposal would repeal WHTC treatment effective for all income during the taxable year covered by the survey, but not for WHTC income which was previously taxed at a lower rate.

Repeal of Less Developed Country Corporation (LDCC) Provisions (p. 9)

At the time of the TIP survey in 1974, income of less developed country corporations (LDCC's) was subject to less U.S. taxation than other foreign source income. There were LDCC exceptions to Subpart F treatment, to foreign dividend gross-ups and to taxation of gain on the sale or exchange of stock in a foreign corporation.

P.L. 94-12, the Tax Reduction Act of 1975, repealed the exception to Subpart F treatment for LDCC dividends which are reinvested in LDCC's, beginning in 1976. The TIP proposal would repeal all of the LDCC exceptions listed above. This would apply to all LDCC income, dividends and gain during the taxable year covered by the survey.

APPENDIX B: INDUSTRIES SURVEYED

The TIP survey recipients included NAM member companies in the manufacturing industries. The following industry groups were used:

SIC		Industry
20	--	food and kindred products
21	--	tobacco products
22	--	textile products
23	--	apparel and other fabric products
24	--	lumber and wood products (except furniture)
25	--	furniture and fixtures
26	--	paper and allied products
27	--	printing, publishing and allied industries
28	--	chemicals and allied products
29	--	petroleum refining and related industries
30	--	rubber and miscellaneous plastic products
31	--	leather and leather products
32	--	stone, clay, glass and concrete products
33	--	primary metals
34	--	fabricated metal products (except ordnance, machinery and transportation equipment)
35	--	non-electrical machinery
36	--	electrical machinery
37	--	transportation equipment
38	--	instruments, photographic goods, watches, and clocks
39	--	miscellaneous manufacturing
49	--	electric, gas and sanitary services

APPENDIX C: DETAILED DESCRIPTION OF THE METHODOLOGY

The economic effects of changes in federal corporate taxes have been studied and debated at length by legislators and the public at large, as well as by professional economists. At issue is the response of investment to changes in corporate taxes. The professional economic literature is robust with many studies of the investment function, going back to classical studies by Jan Timbergen in the 1930's and to Keynes' criticism of monetary policy as having little effect on the level of investment in the General Theory of Employment, Interest, and Money. The broad outline of the investment function is now generally agreed upon; the details and importance of various factors are not.

The problem of estimating the economy-wide effects of corporate tax changes must be viewed from two major perspectives: (1) How do changes in corporate taxes affect corporate cash flow and the user cost of capital? (2) Given the marginal changes determined in (1), that is, the partial equilibrium effects, how will changes in investment and federal tax revenues affect the working of the economy and in turn feed back into subsequent effects on investment? The initial effect can be termed the direct impact on corporate investment spending, while the second element can be termed the feedback effect of tax changes.

The discussion which follows covers the complete methodology of the Tax Impact Project (TIP). Included is a description of the TIP survey form and the responses to it which were received. Also discussed is the microeconomic effect which proposed changes would have on corporations' propensity to invest and to pay taxes along with the assumptions inherent in the analysis. The final section describes the macroeconomic process which estimated the magnitude of the secondary or "feedback" effects based on the changed propensity to invest and to pay taxes.

The Survey of NAM Members

Survey Questions. A survey of industrial companies was necessary to obtain data on the dollar impact of various tax proposals and how they would affect domestic capital investments. The survey form was constructed after the econometric approach was selected and was tailored to provide the type of information necessary to prepare the input for the model. All answers were to be based on the most recently completed taxable year.

The form requested certain company profile information regarding gross sales, number of employees and book value of gross fixed assets. However, this information was not used in the econometric model input. Other company profile questions requested information about the dollar amount of capital invested during the year in fixed assets in the U.S. and about the company's retained earnings for the year.

Each company was asked to state the two digit Standard Industrial Classification (SIC) code number which identifies its general industrial business. The SIC code numbers were used to group survey responses by industry for use in preparing the final survey results as model input.

The form also asked for the initial dollar impact which each of a number of proposals would have had on the federal income taxes of the responding company for its most recently completed taxable year. The company was asked to indicate the year for which it was responding.

A separate cover sheet for the survey provided space for identifying the responding company and the person under whose direction the survey response was prepared. This sheet was used for two purposes: (1) to identify companies so that additional solicitations would not result in duplicate responses, and (2) to provide ready access to a person within each company who could answer any questions about the response.

Survey Distribution and Response. To obtain the responses which would provide the most worthwhile and reliable data for use in preparing model input, the survey was mailed to a selection of NAM member companies in a wide diversity of industries and which are responsible for a significant portion of domestic capital investment in fixed assets.

The fifty largest NAM member companies (by sales volume) in each of twenty manufacturing SIC codes 20 through 39, plus utility company SIC code 49, were included in the list. SIC code 21 contained only 20 companies. An additional 30 manufacturing companies, which were overlooked in the original selection, were sent survey forms at a later date. This list of 1050 large companies was supplemented by 500 small NAM members. The selection was made at random by computer from all NAM companies which employ fewer than 500 persons.

The survey form was mailed to the list of 1550 companies in November 1974. It was sent under cover of a letter which described the purpose of the survey and requested a prompt response of a completed form with the understanding that the information provided would be confidential and that no individual company data would be released.

A total of 360 responses to the survey were received prior to March 1, 1975. Of this number, 344 were from the 1050 largest members and 16 were from the 500 smaller members.

The survey responses were reviewed individually for omitted answers and any other answers which seemed to be incorrect. Responses which were questioned during this process were discussed with the person responsible for the survey. The answers were confirmed or altered as appropriate.

Compilation of the Results. The answers on each response were recorded on the appropriate SIC code list and on a master list. The cover letter with identifying company and individual names were detached and retained. The completed survey forms were destroyed.

A total of 313 responses were used in compiling the results. Because the overall response by the small companies was very limited, none of their individual responses were used. Also excluded were responses from larger firms which needed verification but which did not provide the name of the person responsible for completing the form. Results were compiled for each SIC code and for the total response.

The Microeconomic Effects

The determination of the initial effects of tax changes on cash flow and the user cost of capital can be approached both theoretically and by use of a survey. This first stage of analysis is not amenable to econometric analysis as historic time series data on investment contain the very feedback or macroeconomic effects which are at issue. Also, there have not been sufficient observations to determine the effects of new tax changes empirically.

Many theoretical articles on the effect of taxes on investment have been published of late. While these all permit some degree of qualitative and quantitative conclusions, they exhibit certain deficiencies for the purposes of the TIP analysis.[1] First, theoretical derivations generally give only qualitative conclusions. For example, a model might be constructed which demonstrates that a lowering of taxes will cause an increase in investment. The crucial question for policy purposes, however, is by how much federal tax revenues will change and by what magnitude invesment, employment, and output will change. Purely theoretical constructs do indicate the direction and impact of these changes, but they are less effective in measuring the magnitude of the changes.

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[1] Theoretical models of investment by the firm include references 20, 25, 30, 8, 16 cited in the selected bibliography, pp. 36-37.

The impact of a policy change on tax payments is by no means obvious. It is a complex question that depends upon the current structure of each corporation affected and can only be accurately estimated by someone familiar with the details of both the firm and the tax change. Thus, to obtain answers as to the effect of tax policy changes on corporate tax payments, the TIP survey asks a purely accounting question: Given the conditions of the latest fiscal year, what would be the dollar effect of different tax changes on corporate tax payments?[2] These survey results were then classified by two-digit SIC code.

With the change in tax liabilities determined by the survey, the next question is whether these funds will be retained in whole by the corporation or retained only in part with dividend payments increased. The approach adopted by TIP is that dividend payments are assumed to be unchanged, initially, i.e., they are a part of the "other things held constant." Several studies indicate that while dividends have risen over time, there is no immediate correlation between changes in after-tax corporate profits and changes in dividends.[3] This can be shown empirically by the following regression equation:

$$DDIV = \underset{(6.25)}{.279} + \underset{(2.04)}{.028}*DZA$$

$\bar{R}^2 = 0.04$
DW = 1.65
SE = .389
FIT: 1955:1 TO 1974:4

WHERE:

DDIV = QUARTERLY CHANGE IN CORPORATE DIVIDENDS

DZA = QUARTERLY CHANGE IN AFTER-TAX CORPORATE PROFITS

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[2]Many other surveys have attempted to determine the effect of tax policy change on investment. Among the more notable are the McGraw-Hill surveys that are analyzed in reference 12. A major shortcoming of these surveys (in addition to their small sample size) is that they require an opinion as to how tax changes will affect corporate investment. However, many times decisions concerning investment by large corporations are independent of knowledge concerning the effect of tax policy changes on after-tax profits. Thus, there is a very poor observed relation between these type surveys and other empirical evidence concerning changes in investment.

[3]The classic article on this subject is the paper by Modigliani and Miller, reference 30, which proves that in a perfect capital market optimal investment decisions are independent of how the investment is financed. Dhrymes and Kurz, reference 8, present a model where capital market imperfections make internal funds a cheaper source of financing for the firm. A recent study by Fama, reference 14, finds that the hypothesis of a complete independence between dividend policy and investment decisions of the individual firms cannot be rejected. Also, see references 4 and 29.

Given these results and on the basis of other studies (see Footnote 3), it is assumed that changes in tax liabilities will not immediately affect dividends. Once the initial impact is fed into the model, however, dividends are increased (or decreased) as firms respond to the altered levels of profits and cash flow.

The effect of changes in cash flow on investment can be viewed as a partial equilibrium or microeconomic effect. While many other factors affect the level of investment such as interest rates and the aggregate level of economic activity, the initial effect of such changes can be considered a changed propensity to invest.

TIP assumes that if a particular tax policy were to alter tax liabilities by X dollars, then cash flow would also change by X dollars. Comparing this change in cash flow to total cash flow gives the percentage change in cash flow, which is assumed to result in an equal change in capital investments. This percentage change was computed from the survey data for each SIC code and represents the initial impact of the proposal on that industry, i.e., the changed propensity to invest, if all other factors remain unchanged. This initial impact was used to trigger the model, which then simulated other changes in the economy which would follow the changes in taxes and investment.

The assumption that there is a constant relation between total investment and cash flow is based upon the hypothesis that a firm has an approximately constant leveraging ability in that an increase (decrease) in internally generated funds will allow for an expansion (contraction) in externally borrowed funds, whether this is to be used as replacement investment or expansion investment. Empirically this has been the case. The ratio of total investment to cash flow for the U.S. economy exhibits a remarkably stable pattern over the past 20 years. This is shown in Table 1.

Table 1

AVERAGE RATIO OF FIXED PRIVATE NONRESIDENTIAL INVESTMENT TO CASH FLOW *

Year	Ratio	Year	Ratio
1955	1.1	1965	1.1
56	1.3	66	1.2
57	1.3	67	1.2
58	1.3	68	1.2
59	1.1	69	1.4
60	1.3	70	1.4
61	1.2	71	1.3
62	1.1	72	1.2
63	1.1	73	1.2
64	1.1	74	1.2

*Cash Flow = corporate retained earnings plus corporate capital consumption allowances.

The Feedback Effects: Use of the Macroeconomic Model

NOTE: Most of the data used in constructing the relationships discussed here were prepared by the U. S. Department of Commerce. For specific sources, see pp. 34-35.

Aggregate investment functions have been widely discussed in the literature. (See, for example, reference 26 for a recent survey article; also see selected references, on pp. 36-37.) Since the Data Resources, Inc., (DRI) long-term macroeconomic model deals with an aggregate investment function for the private economy, it was necessary to transform the two-digit industry results into economy-wide effects on investment.

To do this, it was assumed that the TIP sample of manufacturing firms and utilities were representative of the economy in terms of the effect of tax policy changes on changes in fixed nonresidential investment (i.e., producer's durable equipment plus nonresidential structures). In assessing the reasonableness of this assumption, it is informative to examine the historical relation between investment in manufacturing and utilities--the sectors covered by the survey--and investment in other areas.

That is, IFIXER = IM&U + IOT

WHERE:

IFIXER = Fixed private nonresidential investment

IM&U = IPE&M + IP&E49

IPE&M = Investment in manufacturing

IP&E49 = Investment in utilities

IOT = Investment in "other" sectors

Table 2 below presents the historical relationship among these variables annually from 1953 to 1974. IR represents the ratio of IOT to IM&U. The relationship remains quite constant over time, thereby implying that factors impacting investment in manufacturing and utilities have a similar impact on other sectors. (Of course, the timing of the impact can be expected to be different; in particular, manufacturing investment can be seen to be more cyclically sensitive than "other" investment.)

Table 2

HISTORICAL RELATIONSHIP OF MANUFACTURING
AND UTILITY INVESTMENT TO OTHER INVESTMENT

DATE	IFIXER	IM&U	IOT	IR
53	34.1500	16.1925	17.9575	1.10900
54	33.6500	15.2550	18.3950	1.20583
55	38.1250	15.8025	22.3225	1.41259
56	43.7000	19.7950	23.9050	1.20763
57	46.3500	22.1775	24.1725	1.08996
58	41.6000	17.9825	23.6175	1.31336
59	45.1000	17.8750	27.2250	1.52308
60	48.4000	20.3050	28.0950	1.38365
61	47.0250	19.3175	27.7075	1.43432
62	51.6500	19.9225	31.7275	1.59255
63	54.3250	21.1300	33.1950	1.57099
64	61.0500	24.7400	36.3100	1.46766
65	71.3000	29.4375	41.8625	1.42208
66	81.5750	35.5275	46.0475	1.29611
67	83.3000	37.2775	46.0225	1.23459
68	88.8250	38.5475	50.2775	1.30430
69	98.5000	43.2675	55.2325	1.27654
70	100.5750	45.0950	55.4800	1.23029
71	104.5750	45.3200	59.2550	1.30748
72	116.8500	48.2850	68.5650	1.42001
73	136.7500	56.5875	80.1625	1.41661
74	149.1750	66.3950	82.7800	1.24678

Quarterly, from 1955 to 1974, the mean of IR is equal to 1.35866 with a standard deviation of 0.134375, further illustrating the relative stability of this variable.

Another method of examining the relationship between "other" investment and manufacturing and utility investment is to regress the former on the latter, i.e., IOT = f(IM&U). This resulted in the following equation: [4]

$$IOT = \underset{(1.9043)}{2.6638} + \underset{(.053945)}{1.25729} * IM\&U$$

$$\bar{R}^2 = .9661 \quad DW = 1.1171 \quad SE = 3.4691$$

[4] Quarterly, similar regression results are obtained, although the different timing of the changes in investment is apparent.

$$IOT = \underset{(0.903755)}{1.56787} + \underset{(.0265735)}{1.28036} * IM\&U$$

$$\bar{R}^2 = .9639 \quad DW = 0.1938 \quad SE = 3.62815$$

Thus, abstracting from cyclical effects of timing, the relationship between investment in manufacturing and utilities and investment in the rest of the economy is quite stable. Furthermore, the above regressions imply that a change in IM&U will result in an approximately equal percentage change in IOT.

The effects on investment in percentage terms were weighted by the relative level of investment in 1973 for each of the two-digit SIC manufacturing industries and utilities (SIC 49, also included in the survey). This resulted in a weighted-average effect on the propensity to invest which was then introduced into the econometric model.

A number of equations were used by the model to analyze the impact of the various tax proposals on the total economy. The fixed private nonresidential investment (IFIXER) equation is the sum of investment in producer's durable equipment (IPDE) plus construction excluding residential (ICER), and represents the basic investment level altered by the survey results.

IFIXER = IPDE + ICER

In order to illustrate the number of variables in the model which impact the final level of investment, the major elements impacting investment are summarized below. It should be stressed that it is these variables--along with several others which impact the ones listed--which determine the final "feedback" effects of increased or decreased taxes.

ICER = f(DODPCAUS, IPDE, ICR, PICER)

Where:

ICER = Investment in private nonresidential structures
PICER = Implicit price deflator - private nonresidential structures
IPDE = Investment in producer's durable equipment
ICR = Investment in residential structures
DODPCAUS = DOD military prime contract awards - total

IPDE = IPDE58 (PIPDE)

Where:

IPDE58 = Investment in producer's durable equipment - 1958 dollars
PIPDE = Implicit price deflator - producer's durable equipment

IPDE58 = f(KGDPE58, DODPCAUS, GNP58, PGNP, IPDECOST, CASH58, SF58)

Where:

IPDE58 = Investment in producer's durable equipment - 1958 dollars
KGPDE58 = Capital stock of producer's durable equipment - 1958 dollars
DODPCAUS = DOD military prime contract awards - total
GNP58 = Gross national product - 1958 dollars
PGNP = Implicit price deflator - gross national product
IPDECOST = Cost of capital variable
CASH58 = ZA + CCACORP - DIV
ZA = Corporate profit after tax excluding IVA
CCACORP = Corporate capital consumption allowances
DIV = Dividends
SF58 = Final sales, total - 1958 dollars

IPDECOST = f(PIPDE, RMMDCNEWNS, RTCGFS, DPNDIS, RITC)

Where:

PIPDE = Implicit price deflator - producer's durable equipment
RMMDCNEWNS = Average yield on new issues of high-grade corporate bonds
RTCGFS = Statutory corporate tax rate
DPNDIS = Discounted value of depreciation allowances
RITC = Effective rate of the investment tax credit

The weighted average effect on the propensity to invest was incorporated into the fixed nonresidential investment (IFIXER) equation as a multiplier. In other words, the investment equation, which is based upon the user cost of capital and aggregate demand, was multiplied by one plus the fraction that investment would change based on the survey data as subsequently weighted. The percentage change in corporate tax payments was averaged and also included in the long-term macroeconometric model as a multiplier on corporate tax payments. The model was then solved over a five-year period for each tax proposal.

Assumptions of the DRI Long-Term Model

The assumptions of the DRI Long-Term Model of the U. S. Economy basically are such that the economy operates at near full employment after recovering from the initial business cycle.[5] Since the model used by TIP was developed in 1974, the "control" solution returns to near full employment by the year 1975. Thus, the results of the survey give the macroeconomic effects that would occur if the economy were operating at a much more normal level than the current economy. If the survey results were incorporated into the model of today's economy, the effects would, in many cases, be greater because of the correspondingly greater degree of idle capacity at present. However, again, the purpose of the analysis is to develop long-term trend estimates.

The general long-term propositions are:

1. The investment/GNP ratio will be high.

   The model assumes that over the next several years, the economy will be characterized by a major catch-up element for investment because of:

   A. Inadequate outlays in the latter 1960s when the dollar was overvalued and the manufacturing sector was suffering from a depressed rate of return;

   B. The anti-pollution requirements of the future; and

   C. The need to develop new energy sources;

[5] A complete discussion is presented in "Problems and Prospects for the U. S. Economy: Data Resources Long-Term Projections, 1974-1985," Data Resources, Inc., May, 1974.

2. The financing needs for this large volume of investment will be met by large amounts of personal and business saving.

   This requires that the saving ratio be higher than its historical average, which seems reasonable given the maturing nature of the population;

3. Budget deficits will be kept small in accordance with near full employment once the current recession ends;

4. The inflation of 1973-74 represents an historical episode rather than a permanent change in the economic structure; and

5. The growth in potential GNP is 3.9 percent per annum for the first five years of the model simulation, below the 4.7 percent rate of growth during the five years prior to 1974 and consistent with the projected slower population growth.

Major assumptions of the control solution are summarized in Table 3.

Table 3

RATES OF GROWTH OF MAJOR ECONOMIC INDICATORS
FOR THE CONTROL SOLUTION

	Historical 70-74	Control 75-79
Real GNP	4.1	4.3
Gross private domestic investment	6.2	5.2
Fixed investment	6.0	5.3
GNP deflator	5.1	4.4
Unemployment rate (level)	5.4	5.4
Interest rate on high grade corporate bonds	7.5	7.6

DATA SOURCES

DESCRIPTION OF SERIES DIV

Dividends
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income & Product Accounts of the United States, Table 2.2

DESCRIPTION OF SERIES GNP58

Gross National Product--1958 Dollars
Billions of 1958 Dollars
Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES ICER

Investment in Private Nonresidential Structures
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES ICR

Investment in Residential Structures
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES IFIXER

Fixed Private Nonresidential Investment
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES IPDE

Investment in Producers' Durable Equipment
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States, Table 1

DESCRIPTION OF SERIES IPDE58

Investment in Producers' Durable Equipment--1958 Dollars
Billions of 1958 Dollars
Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES IP&E49

Plant and Equipment Expenditures--Public Utilities
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
Survey of Current Business, Jan. 1970; Subsequent Quarterly Issues

DESCRIPTION OF SERIES IP&EM

Plant and Equipment Expenditures--All Manufacturing
Billions of Current Dollars, Seasonally Adjusted at Annual Rates
U. S. Department of Commerce, Bureau of Economic Analysis
Survey of Current Business, Jan. 1970; Subsequent Quarterly Issues

DESCRIPTION OF SERIES PGNP

Implicit Price Deflator--Gross National Product
Index Base: 1958 = 1.0
Seasonally Adjusted
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES PICER

Implicit Price Deflator--Investment, Private Nonresidential Structures
Index Base: 1958 = 1.0
Seasonally Adjusted
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES PIPDE

Implicit Price Deflator--Investment in Producers' Durable Equipment
Index Base: 1958 = 1.0
Seasonally Adjusted
U. S. Department of Commerce, Bureau of Economic Analysis
National Income and Product Accounts of the United States

DESCRIPTION OF SERIES RMMBCNEWNS

Average Yield on New Issues of High-Grade Corporate Bonds
Adjusted to AAA Basis, Per Cent Per Annum, Not Seasonally Adjusted
Courtesy of the Economics Department
The First National City Bank of New York
Estimates Beginning April 1972 Computed by DRI

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Sharing the Cost of Government Fairly

(By the United Church of Christ, June 1969)

Christians recognize that government has an important place in the providence of God in meeting His purposes and human needs. Christian Stewardship regards the payment of taxes, levied through the democratic process, as a public duty, and their responsible use as a public trust. In the interest of justice, we insist that the revenues necessary to meet the expenses of government must be apportioned with utmost fairness.

TAX CRITERIA

Taxes, while primarily a source of governmental revenue, intentionally or unintentionally also affect the economic and social process. Tax policy, therefore, requires difficult choices to be made in accordance with the relative weight given to diverse, sometimes contradictory, norms. The following criteria, however, are basic in a just system:

(1) *Adequacy.*—Taxes should provide adequate revenue for the government.

(2) *Simplicity.*—The law should be understandable to the taxpayer and relatively easy for both taxpayer and government to administer.

(3) *Distributive Justice.*—Taxes should fall on taxpayers in accordance with their ability to pay. While income is not the only element in a measure of ability to pay, it is proper for individuals with higher incomes to be taxed at successively higher rates, other things being equal. Regressive taxes—which take a larger share of income from the poorer taxpayer than from the richer—should be used sparingly and avoided entirely whenever possible.

(4) *Neutrality.*—Taxes should not create artificial incentives for making economic decisions except where explicitly intended as a matter of public policy. Even then, the end sought may be more effectively and forthrightly achieved through properly designed controls and incentives.

(5) *Vitality.*—Both the nature and extent of taxation should be designed to enhance rather than inhibit economic efficiency, healthy non-inflationary growth, and productivity in a socially constructive manner.

(6) *Encouraging Voluntary Agencies.*—The tax structure should continue to stimulate the use and development of voluntary agencies for their salutary contributions to our life.

TAX SYSTEM SHORTCOMINGS

In the light of these principles, we believe that major reliance should be placed on the income tax. But we call attention to certain shortcomings in present United States tax policy.

(1) *The tax system does not meet the test of equity.*—Since 1913 the United States has accepted the principle that a person's income tax should be related to his ability to pay, and that those enjoying greater income should contribute a larger percentage in taxes than those with a smaller income. Nevertheless, this rule is inequitably applied in practice. The mass of our citizens, who work for wages and salaries, pay full tax on their incomes. Yet in 1965 individuals reporting incomes over $1 million paid, in the aggregate, income taxes amounting to less than 31% of the net taxable income which they actually reported. They paid far less than this percentage of their total income, although the *nominal* rate scale called for a tax of at least 67%.

In 1967, there were 155 Americans with incomes in excess of $200,000 who paid no federal income tax at all.[1] At the other end of the income scale there are persons who pay income tax on annual income of less than $2,000, in addition to Social Security payroll taxes and a host of state and local taxes.

These disparities are not due to dishonesty in reporting. In great measure they are the result of legal "loopholes" which favor certain forms of income as over against others or apply inconsistent criteria in defining the (untaxed) costs of earning income.

These inequities were intensified by the 10% surtax of 1968. This measure taxes at a still higher level those of moderate income who already pay taxes. It taxes at a minimal rate, or not at all, those who are able to escape a full share of the tax burden.

Tax reform, largely deferred when taxes were reduced in 1964 and substantially denied when taxes were increased in 1968, is important to counteract the

[1] Testimony of former Secretary of the Treasury Joseph Barr before the Joint Economic Committee of the Congress.

prevailing bitterness and sense of injustice. It would assure that the burden will fall fairly on all the American people, not just on those powerless to secure preferential tax immunity or relief.

(2) *The tax base does not meet the test of adequacy.*—The federal tax base has been eroded by many provisions that permit vast amounts of real income legally to avoid inclusion in net taxable income. As a result, those who can benefit are too much concerned with the technicalities of tax avoidance; and a high rate scale is applied to those forms of income which are fully taxed. Our direction must be toward a broader tax base involving fewer tax preferences, with a consequent reduction in rates.

(3) *Tax inequities prevent counterbalancing fiscal policies.*—In order to carry out its responsibilities to eliminate unemployment and inflation, the government needs effective tools and techniques. One of the most important ways of achieving these objectives is by adjusting income tax rates to counteract adverse economic trends. To be most useful, however, these changes must be enacted as soon as such problems appear. So long as our tax law is laden with complexities and inequities, Congress will be reluctant to alter tax rates to meet national economic requirements.

(4) *The inequities of the federal law become inequities in state taxation.*—Many states compute their own income taxes on a base that is identical with that for the federal tax, except for minor modification. As a result, the state income tax heightens the inequities of the federal tax. This inequity is intensified by state reliance on property, sales, and other taxes that have undesirable impacts on economic efficiency, urban development, housing, and the living standards of the poor. States cannot take the lead in tax reform without increasing the compliance burdens of taxpayers. Reform at the federal level, therefore, is essential for the improvement of state fiscal systems.

PROPOSED REFORMS

We recognize that a revision of the federal tax structure involves many technical questions. Nevertheless, we ask for correction of certain glaring and obvious deficiencies:

(1) *All personal income, whatever its source, should for tax purposes be treated on essentially the same basis, and be subjected to a graduated rate of taxation which is progressively heavier as the total amount increases.*—Any exceptions must be fully justified by a vital social or economic purpose, and must be scrutinized particularly as to their effect upon the less affluent members of society.

(2) *In the interest of greater equity and adequacy, the following steps should be taken to correct existing preferences and inconsistencies:*

(*a*) Interest paid on bonds hereafter issued by state and local governments should be taxed like income from other investments. In order to make this change financially feasible for state and local governments, federal grants and/or low interest loans to such governments must be provided to offset the otherwise increased interest costs. This would be preferable and cheaper than the present hidden subsidy by tax exemption, which is no longer required by constitutional interpretations.

(*b*) Corporations should be allowed to deduct cash dividends as a business expense in determining their taxes, just as interest payments are now deducted. This would eliminate "double taxation" and tend to encourage the sale of new stock.

(*c*) The present preferential treatment afforded most capital gains should be eliminated and such gains should be taxed at the same rates as other income. Provision should be made for *averaging* the gains over the years involved to prevent unduly high rates for a single year. It is contrary to most notions of fairness that capital gains income should be taxed at lower rates than income earned as wages or salaries. Such preference also injects an artificial influence into business decisions. There are better ways to improve the vitality of our economy.

(*d*) Provisions for averaging income for tax purposes should be simplified and extended to taxpayers not presently enjoying this advantage. Persons who receive the bulk of their income in a relatively short period of their working life tend to pay higher income taxes over their lifetimes than those receiving their income more evenly throughout their productive years.

(*e*) The preferential treatment extended to taxpayers who invest in oil, gas, and mineral properties should be ended. Depletion deductions, like depreciation

deductions available to taxpayers in other fields, should be limited to the amount of the taxpayer's actual investment.

(*f*) Federal estate and gift taxes should be revised to permit a husband or wife to receive property from the spouse tax free; but the law should not permit wealthy families to avoid estate taxes for generations by the use of long-term trust arrangements.

(*g*) Provisions permitting profits on property appreciated in value to escape tax free at the owner's death should be changed so that where no inheritance tax is paid the recipient of inherited property takes the decedent's basis for the property.

(*h*) Property contributed to spurious, tax-haven foundations which do not significantly serve social purposes should no longer confer the benefits of tax deduction on the individuals who created them.

(*i*) Businesses and property of churches, foundations, educational and charitable organizations, but unrelated to their normal religious, educational, and humanitarian pursuits, should be taxed at the standard rates applicable to businesses and property not so owned.

(*j*) We oppose use of a threshold principle below which charitable gifts would not be deductible.

(3) *The income tax should be completely eliminated for those below the poverty line, and should not fall so heavily upon those immediately above the poverty line that they are thereby brought below it.*—Millions of citizens living below the subsistence level already pay unduly large portions of their income, sales, Social Security, and other taxes.

(4) *Any further increases needed to augment our Social Security trust funds for higher benefits to persons below or near the poverty level, should come from general revenues, principally the graduated income tax, rather than from increased taxes on the low income worker's take-home pay.*[2]

We recognize that these initial efforts will not eliminate all inequities, but they will provide a worthy beginning. We must remove any ground for the cynicism which results when the tax system favors the citizen who can afford a lobbyist or high priced tax adviser, and places a disproportionate share of the cost of maintaining the peace or eliminating want upon those who are below, at, or immediately above the poverty level. The sense of shared enterprise and purpose will be real and deep only when each person who is required to help finance the national effort knows that each of his fellow citizens is sharing the burden as he is, and that all income is given equal treatment.

This pronouncement was adopted by the Seventh General Synod, United Church of Christ, June 1969.

AMERICAN PUBLIC POWER ASSOCIATION,
Washington, D.C., March 8, 1976.

Hon. WALTER MONDALE,
Chairman, Tax Policy and Tax Expenditure Task Force, Senate Committee on Budget, Washington, D.C.

DEAR SENATOR MONDALE: American Public Power Association wishes to submit for the consideration of the Tax Policy and Tax Expenditure Task Force of the Senate Committee on Budget and inclusion in its hearing record the enclosed statement (a) opposing further tax subsidization of private power companies as proposed by the Ford Administration and (b) supporting termination of the use of pollution control bonds as recommended by the Treasury Department.

Sincerely,

LARRY HOBART.

STATEMENT BY AMERICAN PUBLIC POWER ASSOCIATION

American Public Power Association is a national service organization representing some 1,400 local public power systems—mainly municipal electric utilities—in 48 States, Puerto Rico, the Virgin Islands, and Guam.

APPA urges that the Tax Policy and Tax Expenditure Task Force (a) oppose further tax subsidation of private power companies as proposed by the Ford Administration and (b) support termination of the use of pollution control bonds as recommended by the Treasury Department.

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[2] How best to assure a reasonable minimum income to those living in poverty is not the subject of this pronouncement. Better Social Security, an improved welfare system, and the use of a negative income tax for these purposes are still under review by the CCSA.

Utility tax aid

President Ford has this year renewed his 1975 request for Congressional approval of an electric utility tax program which includes a permanent increase in the investment tax credit to 12% (except for generating facilities fueled by petroleum products) and its immediate application to progress payments for long-leadtime projects; extension of five-year fast tax writeoffs for certain pollution control equipment and allowance of similar rapid amortization for conversion or replacement of petroleum-fueled generation; permission for use of depreciation for tax purposes on non-petroleum burning plant construction expenditures as made; and opportunity for shareholders to postpone and reduce tax on common stock dividends when paid in stock.

APPA has reviewed the Administration's utility tax proposals and wishes to offer the following comments for the consideration of the Tax Expenditures Task Force:

1. OFFICIALS OF THE FORD ADMINISTRATION HAVE STATED THAT THE PROGRAM IS UNNECESSARY

A paper on "Energy Requirements and Federal Policy Actions" presented by Richard H. Williamson and Edward J. Hanrahan of the U.S. Energy Research and Development Administration on November 19, 1975, at the winter meeting of the American Nuclear Society in San Francisco, California, observed that: "It is true that new plants are far more costly than previously experienced so that continued pressure is exerted on the financing capabilities of the utilities. However, the financial and cash-flow positions of most utilities have improved substantially in recent months. Though much delayed, rate increases over and above fuel escalation clauses are being regularly granted by state public utility commissions. Investor confidence is returning as evidenced by the regular marketing of securities and the upward rise in stock prices. The reduced construction programs caused by the lower growth is assisting the management of cash-flow problems. Even if inflation continues to escalate plant costs, one must recognize that rate increases will be granted to keep pace with the inflation although time lags will occur."

After reviewing "a number of potential policy or legislative changes to improve the financial health of electric utilities," including the Electric Power Facility Construction Incentive Act of 1975, and considering their impact, the authors concluded that: "* * * it is not entirely clear that adoption of Federal proposals will really have a great effect today. It appears that the financial health of the utilities is steadily improving, even in the almost total absence of Federal assistance. It also appears that the forces of the energy-economic system have worked to remove a large part of the capital requirements problem in little more than a year since the financial difficulties of the utilities became widely known."

A copy of the complete paper is attached.[1]

More recently, in February of this year, Assistant Treasury Secretary Sidney L. Jones reportedly told a conference sponsored by the University of Florida's Public Utility Research Center in Gainesville, Florida, that electric utility earnings had "come back too fast" for utilities or investors to expect a tax break for those re-investing their dividends in utility stocks. According to the trade publication *Electrical Week*:

"He said that much of the concern that the Administration and Congress had last year for financially strapped utilities 'has been dissipated' by the 'generally improved financial showing' of the industry. Asked later if the Administration would push President Ford's six-point, $600-million tax-relief plan for utilities, Jones said only: 'That remains a part of the program'."

A copy of the *Electrical Week* February 9 story is attached.

The same issue of *Electrical Week* carried a headline reporting that "Utility Stock Market Has the Bull by the Horns." The accompanying story declared:

"The bicentennial bull market that has kicked off 1976 has included healthy gains for most electric utility stocks. And most Wall Street analysts and underwriters who follow the industry believe that these increases, although benefiting from overall market strength, also reflect stronger utility finances that should lead to improved performance even beyond the current surge. One result of the higher common stock prices will likely be heavier sales of utility equity, espe-

[1] See p. 111.

cially early in the year. This also may mean greater financing flexibility if a need is seen to restore some construction cutbacks later in 1976."

A copy of the story, which contains additional detail, is attached.[2]

2. PRIVATE POWER COMPANY OFFICIALS HAVE GIVEN SUPPORT TO THE BELIEF THAT ADDITIONAL FEDERAL FINANCIAL AID IS NOT NEEDED

The board of directors of the Edison Electric Institute, the national association for privately-owned electric utilities, at a meeting in January in Phoenix, Arizona, agreed that Federal funding for conventional electric generating plants which might be available through the Administration's proposed Energy Independence Authority is neither wanted nor needed. EEI asked for elimination from the EIA proposal of any suggestion that Federal money would be used to finance conventional nuclear or fossil facilities. "There's just no need for that," W. Donham Crawford, EEI president, asserted. EEI reported in February that the electric utility industry raised $12 billion in capital—a financing record—in 1975, and that state regulatory commissions approved a record-high of $3.1 billion in rate increases last year (up from $2.2 billion in 1974).

3. FINANCING PROBLEMS OF UTILITIES ARE NOT BASICALLY TAX PROBLEMS

Secretary of the Treasury William Simon told the Ways and Means Committee last year that "We have said that the most fundamental problem with respect to electric utilities is the problem of adequate rates." He said that: "So long as rate commissions refuse to approve rates sufficient to provide an adequate return to capital, investors will be unwilling to invest in the industry, regardless of the rate of capital formation or the aggregate amount of capital available." He pointed out that certain utilities are experiencing problems of cash flow, high interest rates, and debt-equity ratios, and reiterated: "Again, these problems are not basically tax problems." If this is so, why attempt to treat them by amending the Internal Revenue Code?

4 POSTPONEMENTS AND DELAYS OF UTILITY PLANTS ARE CAUSED BY FACTORS OTHER THAN FINANCING

Secretary Simon did not discuss other major—and perhaps primary—reasons for postponement or cancellation of generating plants, which include, according to the National Electric Reliability Council, "the numerous problems associated with siting, regulatory requirements, environmental procedures and litigations, jurisdictional conflicts of governmental agencies, and equipment deliveries." Alteration of the Federal tax code will not solve these problems.

5. THE ADMINISTRATION PROGRAM WOULD BENEFIT THOSE IN "REASONABLY FAIR HEALTH"

The program may not benefit those companies which are probably in the greatest need of financial assistance. Air would be supplied primarily in the form of Federal tax relief, despite the fact that, according to the Federal Power Commission, privately owned electric utilities in 1974, the most recent year for which Federal Power Commission statistics are available, paid only 1.4% of their total electric operating revenues in Federal income taxes, and in 1973 about 50 power companies—one-fourth of the Nation's major power companies—paid no Federal income taxes at all.

Furthermore, it would appear that if financial assistance for private companies is needed, it should be applied on a case-by-case basis, rather than "blanket" relief which provides assistance for those who are not in need as well as those in need.

The necessity of a case-by-case analysis is apparent in a comment by Gordon Corey, Vice Chairman of Commonwealth Edison Co. and Chairman of the Federal Power Commission's Technical Advisory Committee on Finance.

Indicating "enthusiastic" support for tax relief for private power companies, Mr. Corey observed to *Energy Finance Week* that the proposals advanced by Secretary Simon will help only companies "in reasonably fair health." It would seem questionable public policy to embrak upon a long-range tax program which

[2] See p. 115.

awards unique advantages to a sector within a selected industry which is "in reasonably fair health."

Secretary Simon has said that: "The increase in the investment tax credit will be a cash contribution by the Federal government for the construction of additional electric power plants." If such special transfer payments in the form of tax relief are to be made, clearly each case should be examined to insure that financial aid is justified. Federal welfare programs available to low-income families impose means tests or qualification requirements. It would seem that no less scrutiny should be paid to utility clients of the government which seek income maintenance programs.

6. THE PROGRAM IS DISCRIMINATORY

As previously indicated, *some*—but not all—privately and publicly owned electric utilities have reported financial difficulties which have adversely affected acquisition of new plant and equipment that may be important in supplying future electric demand.

As a remedy to this situation, the Administration has recommended a number of new tax breaks for *all* private power companies—regardless of need. No comparable program has been proposed by the Administration to assist *any* publicly-owned power systems, which serve 13.5% of the nation's electric consumers, although similar problems may exist in this segment of the utility industry. The Administration plan is therefore discriminatory.

Furthermore, the Secretary has proposed special tax benefits for *one* sector of private business which enjoys unique protective devices. As then-Secretary of the Treasury Douglass Dillon pointed out in 1962 in arguing against availability of the investment tax credit to utilities: "This recommendation was made with full recognition of the great contribution that utilities make to the American economy. It was based on the fact that public utilities are regulated monopolies with substantial assurance of a given rate of return on investment after tax. Moreover, investment in public utility facilities is based largely on demand, governed by public requirements." The Department of the Treasury noted at that time that: "In return for their authorization to operate as regulated service corporations, they are assured consumer rate charges which will cover their costs of operation, including Federal income taxes, plus a just and reasonable rate of return on investment. This rate of return is so set as to attract the capital needed to serve the public convenience and necessity. For the vast majority of utilities the rate of return presently available, when adjusted for the lack of risk on that investment, equals or exceeds the rate of return in other industries. Furthermore, the rate of return is gauged to enable the utility to obtain adequate capital at whatever cost is required."

While private power companies may disagree with specific decisions of regulatory commissions, there is no question that they operate within a protective framework which is not available to a host of other businesses—many of whom would undoubtedly argue that they are more logical candidates for tax relief than utilities.

7. CONTRIBUTIONS TO EMPLOYMENT MAY BE MARGINAL

Another stated goal of the utility tax package promoted by the Administration is creation of jobs. However, a 1972 subsidy study prepared for the Joint Economic Committee to determine the usefulness of the 7% investment tax credit in reducing high unemployment concluded that the credit does not correct this market deficiency as proponents originally argued. The study estimated that the credit would reduce unemployment by 0.1% in one year and 0.3% over a 2½ year period.

Leonard Woodcock, President of the United Auto Workers Union, in testimony last year before the Ways and Means Committee, pointed out with respect to the investment tax credit that:

"As representatives of the UAW have stated before Congress many times, while described as incentives, investment tax credits are in reality windfalls. They are available for investment that would have been made in any event as well as for any—inevitably relatively small—amount of additional investment that might be attributable to it. (In fact, the credit is available even to a firm that responds to the incentive by *reducing* the amounts of its investment below previous levels.)

Thus, in the unlikely event that the credit stimulates an investment increase of as much as 10 percent, more than 90 percent (100 divided by 110) of the credit will represent tax revenues wasted in paying businesses for investment made for reasons that have absolutely nothing to do with the credit.

"Tax breaks for business are usually sold as a spur to savings and investment, which will ultimately provide more jobs. It is obvious, however, that the effect of the credit on the level of investment marginal, at best, its contribution to employment must also be marginal."

Mr. Woodcock also told the committee that:

"Our recommendation to let the corporate tax cuts in the Tax Reduction Act expire at the end of 1975 extends to those cuts favoring the private power companies. Smilarly, we do not support any of the other tax subsidies for the industry that the Administration is actively pursuing. These again are examples of blanket solutions which fail to distinguish between utilities in need and those which do not require aid. If enacted, these loopholes would continue to generate tax privileges and lost revenues long after the need for them, if there ever was one, has passed.

"As I stated above, the 'by case' approach is the only efficient and equitable way of dealing with this problem."

8. POWER COMPANIES COULD BE ELIMINATED AS TAXPAYERS

Adoption of the Administration's solutions would reportedly reduce private power companies' tax liabilities by $600 million in fiscal year 1976 and by an increasing amount in subsequent years. The initial annual tax relief is greater than the $521 million in Federal income taxes paid by all private power companies in 1974. Due primarily to prior tax subsidies, private power companies paid only 1.4% of total electric operating revenues in Federal income taxes in 1974, continuing a 20-year downward trend.

Congress has already increased the investment tax credit for private companies by 250% for the years 1975 and 1976, and liberalized its availability. This subsidy is in addition to other tax advantages previously made available to private power companies, including use of municipal bond financing for pollution control equipment. The additional tax favors requested by the Administration not only would discriminate against other ownership segments of the electric utility industry and other kinds of business organizations (which may have financial problems that are more pronounced than utilities), but could eliminate private power companies as Federal income taxpayers—even though they might continue to collect such taxes from their consumers.

Secretary Simon's testimony suggests that if special tax benefits of this kind are to be made available to needy industries, private power companies may not be the place to start. He noted that after-tax profits of manufacturers account for 5¢ of every dollar of sales. However, FPC 1974 statistics show that the comparable figure for private power companies is 14¢ of every dollar of sales.

9. THE PROGRAM WOULD MANDATE POLICIES BY STATE COMMISSIONS

Administration proposals for eliminating tax liabilities of private power companies are conditional on regulatory agency "normalization" of the tax benefits and inclusion of construction work in progress in rate base. This approach seeks to use the Internal Revenue Code to stimulate so-called "mandated reforms" in utility regulation which the Administration has previously proposed. Congress has thus far declined to approve these suggestions for Federal pre-emption of regulation by state commissions, which are responsible for scrutiny of retail rates and certification of new plant, principally because the charges have been construed as unfair to consumers, who experienced in estimated $8 billion increase in electric rates in 1974. The Administration is proposing that the Congress second-guess regulatory commissions on the merits of particular rate making policies. This would be done by attempting to prevent further rate base deductions or flow-through of tax benefits and to compel consumers to pay for plants which are not providing them with electricity.

10. TAX INCENTIVES NOT ESSENTIAL TO ENCOURAGE NONPETROLEUM CONVERSIONS OR REPLACEMENTS

While minimizing importation of foreign oil is one of the alleged aims of the utility tax program outlined by the Administration, it is not clear that tax incentives are essential, in most instances, to encourage non-petroleum generation con-

versions or replacements. The high price of oil coupled with legislation passed or pending in Congress to require coal conversion or capability for generating stations moves utilities in this direction without benefit of new tax breaks, although some forms of aid may be needed in specific cases.

As for nuclear facilities, it is of interest to note the Atomic Industrial Forum report that:

"Since the first nuclear generating station entered commercial service in 1957, significant conservation of resources and economies in power costs have been expected. That promise has now been realized.

"Today, almost 60 nuclear power reactors are available to operate, some 70 are under construction and more than 100 are planned by the nation's electric utilities.

"Those plants in service during the first nine months of 1975 generated more than 121 billion kilowatt-hours or about 8.5 per cent of all commercial electricity.

"Had this amount of energy been generated instead at fossil-fired stations, some 40 million additional tons of coal or about 7.5 billion additional gallons of oil would have been needed during that period.

"Further, these nuclear plants produced a savings in total generating costs of approximately $1.35 billion.

"For the average residential customer on these utility systems—assuming all his electrical requirements were met by nuclear plants—the projected savings on his annual bill would have been nearly $40 compared to coal, more than $175 compared to oil.

"Nuclear power, then, is not only a necessary but also an economical means of meeting our energy demands."

11. IMPROVEMENT IN UTILITY OPERATIONS ALSO COULD IMPROVE FINANCIAL PICTURE

Frank Zarb, Administrator of the Federal Energy Administration, has emphasized that improvement of utility operations could improve significantly the utility financial picture.

The Federal Energy Administration has pointed out that the electric utility industry could save capital—and fuel—by improving availability of major generating units and increasing their capacity factor. FEA stated in a March, 1975 report on "Improving the Productivity of Electric Powerplants":

"On average, the Nation's nuclear and large fossil-fueled units are forced out of service more than 15% of the time, are unavailable for service more than 25% of the time, and operate at less than a 60% capacity factor. Improvements in capacity and availability factors and reductions in forced outage would yield near-term and long-term benefits for ameliorating the effects of such severe industry problems as financing, high fuel costs, siting and licensing.

"The potential financing benefits of improved productivity are large By 1980, an industrywide reduction in the average forced outage rate of just 1 percentage point could reduce the Nation's installed capacity requirements by up to 6,800 MW and capital requirements by as much as $1.8 billion (1974 dollars). Over this same period, a capacity factor increase of 8 percentage points for nuclear units and several percentage points for 400 MW and larger coal-fired units would permit an increase in output from these units equivalent to the electric energy produced by burning more than 500,000 barrels of oil per day. At projected costs for oil, coal, and nuclear fuel, this could reduce the utility industry's total fuel costs in 1980 by approximately $3 million per day (1974 dollars)."

FEA's views on this sbject were further expounded by Administrator Zarb at a June load management conference in which he said his agency will seek to cut power plant expansion one-third (70,000,000 kw) by 1985, at a capital savings of $49 billion. A key to reaching the reduction is to boost the utility industry's average plant capacity factor from 49% to 57%.

12. PRINCIPLES FOR ANY NEW FINANCIAL AID PROGRAM SHOULD BE ENUNCIATED

If Congress determines that new Federal programs of financial support for some utilities are desirable, they should be founded on four principles:

(*a*) Avoidance of "blanket" solutions which do not distinguish between utilities in need and those which do not require aid.

(*b*) Use of direct, open funding or backup help through a designated Federal agency as opposed to hidden subsidies such as tax breaks.

(*c*) Availability of assistance to all segments of the electric utility industry regardless of ownership.

(*d*) Protection of the public from misuse of Federal aid by recipients.

As far as emergency situations are concerned, a Federal program of this type already exists in the Federal Reserve Act. The Federal Reserve System has a general contingency plan which encompasses lending to electric utilities. Authorization for the program was approved by Congress in the 1930s. Aid can be granted in unusual and exigent circumstances, as determined by the FRS Board of Governors. The plan is applicable to both public and private utilities.

Should Congress determine that additional aid is needed for selected utilities which can demonstrate a need for assistance, an agency with the power to make or guarantee borrowings might perform this function. But creation of such an agency is not a tax matter.

Pollution control bonds

As you know, in 1968 Congress restricted the issuance of industrial development bonds, where state and local governments issue tax-exempt bonds to be utilized by private businesses. However, Congress did permit industrial development bond financing for certain purposes, including pollution control.

In his testimony before the Ways and Means Committee last year, Secretary Simon noted the rapid growth of tax-exempt financing for pollution control facilities, and indicated that such revenue bonds may currently account for about 15% of the new issue exempt market. He pointed out that the impact of these issues is to tighten the municipal bond market and push up interest costs, and also observed that:

"The emphasis on environmental protection has caused major changes in modern technology and the adoption of new manufacturing processes designed to minimize pollution. The attempt to segregate the cost of such facilities as between the cost of the basic technology and the cost of pollution control has become an administrative nightmare and is, in fact, well nigh impossible."

Because of their adverse market and administrative features, Secretary Simon recommended that industrial development bond financing be further limited by permitting tax-exempt pollution control financing only for separate facilities added to plants in operation before January 1, 1975. "This proposal would help reduce the cost of upgrading existing properties but recognizes that in new plants pollution control and production usually can't be separated," he said.

An analysis prepared by the Municipal Finance Officers Association suggests that if Congress does not act, pollution control issues could grow through the decade to $6 billion or more in annual sales, and that their volume will increase relative to other tax-exempts. "As the volume of pollution bonds grows, their added volume and higher yields drive up rates on all tax-exempt bonds, anywhere from 5 to 20 basis points (at a 20-year maturity) per billion of annual pollution bond financings, depending on market conditions," the MFOA study states. "Pollution control bonds are most directly competitive with other long maturity, term-structure and lower quality tax-exempt bonds and, therefore, they force up rates on these bonds to an even greater extent—an estimated 25 basis points or more under tight credit conditions."

The problem posed by pollution control bonds was analyzed in a December, 1975, article in *Fortune* which reported:

"The pollution-control bond gives the corporations a triple or, in some cases, a quadruple subsidy. The company gets the benefit of the state's lower borrowing costs. It can also treat the pollution facility as its own property, and so depreciate it on an accelerated basis. And, under certain conditions, it may even be able to deduct a part of the lease payments as business expenses. As if that were not enough, in most states, pollution-control facilities are exempt from local property taxes.

"Pollution-control revenue bonds represent a discriminatory handout, in that small companies usually cannot get states to authorize such bond issues, and even if they could, investors might be reluctant to buy the bonds. Perhaps most important, the ready availability of long-term subsidized borrowing for pollution control tends to produce a bias in favor of highly capital-intensive waste treatment as opposed to alternative methods, such as adjustments in production processes, that might achieve the same results as lower capital costs. Hence, the pollution-control bond leads to a profligate use of capital.

"The volume of pollution-control issues has increased phenomenally in the past few years. According to the Securities Industry Association, pollution-control bonds totaled slightly over $1 billion in the first half of 1975. But most bonds of this kind are privately placed, and the S.I.A. data pick up only

a small proportion of private placements. Robert Gerard, a deputy assistant secretary of the Treasury in charge of capital-market policy, thinks the amount of pollution-control financing—public and private—has already reached somewhere between $4 billion and $7 billion this year.

"George Petersen, an economist with the Urban Institute, calculates that, if the larger of these estimates is correct, the pollution-control bond probably accounted for a rise of about 80 to 85 basis points in municipal-bond interest rates. That would represent almost two-fifths of the total rise in rates since the beginning of 1975.

"Anguished protests against pollution-control bonds have come from enlightened municipal finance officers as well as from many members of the underwriting community. Says Lennox Moak, the tart-tongued but highly respected finance director of Philadelphia: "In 1974 Pennsylvania authorized about $1.9 billion in pollution-control revenue bonds. That is only $200 million less than the total amount of traditional municipal issues sold by both the state and its local subdivisions throughout the year. I have told the advocates of pollution-control bonds just one thing: 'Get the hell out of my market! You are ruining it!'" Recognizing the dislocations caused by pollution-control bonds, the Municipal Finance Officers Association is now advocating an end to their tax-exempt status and the substitution of a system of tax credits for corporations undertaking cleanup campaigns."

In 1974, out of a total of $1.6 billion in pollution control bond sales reported by the Daily Bond Buyer, $928 million were issued for the benefit of private power companies. The paper reports that: "In 1974, electric utilities were the most frequent and largest users of the IDBs. Of the 114 reported transactions, 47 were for electric utilities or 41.2%. They consumed 56.3% of the total dollar amount." While the private power companies share of such financing was down in the first half of 1975 (17.3% of the financings and 24.2% of the dollar total), it still totaled $240 million. In addition, a list of pending pollution control issues published by the *Daily Bond Buyer* showed that private power companies would be the beneficiaries of nearly $2 billion in additional tax-exempt pollution control bonds—a sum almost twice as large as all the revenue bonds issued by municipal electric utilities in 1974.

Secretary Simon has told the Ways and Means Committee that the Treasury Department views the proliferation of pollution control issues as a prime factor in increasing "drastically" the interest costs on municipal bonds and in causing cancellations and postponement of new issues. He has called for repeal or restriction of such financing. APPA commends the Secretary for his recognition of this problem, and urges that the Congress take action to terminate use of pollution control bonds.

Energy Requirements and Federal Policy Actions

(Presented by Richard H. Williamson and Edward J. Hanrahan, U.S. Energy Research and Development Administration before the American Nuclear Society Winter Meeting, San Francisco, Calif., Nov. 19, 1976)

The purpose of this paper is to discuss some likely courses of development of the electrical energy system during the next ten years. By this time, everyone associated with the energy business is quite familiar with the structural changes in the Nation's total energy and electrical energy consumption patterns during the previous two years. It has been a period where fuel costs have risen dramatically, where international moves and countermoves have taken place relating to fuel imports, where emphasis on conservation of energy through laws and persuasion has occurred, and where the forces of environmental concern have really affected our methods of energy production.

Yet, it is still too early for us to ascertain the magnitude of the energy consumption or production changes due to each particular factor. These changes mean that our past correlations of influencing factors may not be valid for future projections, that limited information exists in quantitative form for adjusting our correlations, and that the future behavior of the important variables is highly speculative. These uncertain conditions are evidenced not only by the rapid changes in forecasts of future energy patterns but also in the flux of corporate decisions and governmental policy action.

During the past year, new projections for the quantity and mix of electric generating stations have been derived from analysis of detailed energy end use patterns and fuel substitution possibilities. Analytical tools developed in the

Office of the Assistant Administrator for Planning and Analysis, Energy Research and Development Administration, and at Brookhaven National Laboratory have been used to examine a full range of energy substitution possibilities during the next decade. Our procedure has been to examine aggregate energy-economic growth patterns as well as a detailed network of energy flows from extraction to end use.

DISAGGREGATED ECONOMIC ACTIVITY

Various assumptions concerning population growth, the unemployment rate, labor force participation, productivity, and capital stock were used to estimate real Gross National Product growth. At the time, our set of analytical tools did not permit direct linkage to the disaggregated level of economic activity required in the network analysis so that an indirect judgemental process was required. This deficiency has been recently corrected through the development of a specially constructed inter-industry model, but was not available for application to the projections reported here. Thus, nominal levels of industrial output, commercial activity, transportation services, and housing stock were somewhat exogeneously specified for future time periods based on general relationships with real GNP and relative price changes of goods and services.

The disaggregated economic activity is described in terms of the square footage of residential and commercial space to be heated and cooled, the stock of appliances, the tons of output from major energy using industries, the passenger miles travelled in private autos and airplanes, the ton-miles of freight transported by truck, rail, and ship, and other such indicators. This economic activity generates a derived demand for energy needed to produce these goods and services, energy that can be supplied by several alternative energy forms. This technique permits explicit examination of energy substitution possibilities such as electric space heating for direct fuel heating or the greater use of coal to provide process heat. It also allows introduction of new technologies or more efficient devices at the point of energy end-use.

Based on the alternative energy forms in the utilizing sector, a derived demand for energy supplies in the form of electricity or direct fuels is generated to determine the total energy and electric energy requirements. Of course, the energy supply possibilities are subject to constraints perceived to exist in the future regarding the availability or growth potential. The determination of the allocation of energy flows within the system network is aided by the use of linear programming model that provides indications of the optimal energy patterns based on technical efficiencies, environmental emissions, and relative costs of technologies as we know them today.

The projections have been established for a range of possible future conditions, but the results and conclusions reported here focus only on a small range of values that appear likely based on our most recent appraisal of the situation. For the next decade, a slower growth rate of total energy resources consumed is projected, particularly in the residential and commercial sectors. However, a reduction in the growth rate for total energy demand does not necessarily imply either the advisability or the certainty of a proportional reduction in the growth rate of electricity demand. The analysis indicates that energy inputs to the electric sector will continue to grow as a proportion of total energy inputs and that there will be continued substitution of electricity for direct fuel consumption. The analysis also indicates, however, that electric power growth probably will not return to the historic 7 percent growth rates as an annual average rate during the next ten years.

NEW POWER PLANTS

The picture for the installation of new power plants during the next ten years is rather erratic. There is substantial excess capacity existing in the utility system today. The time path for reduction of this excess can take a number of forms but in any case the number of new installations for the next five years will be low relative to the previous five years. The reasons for this situation can be explained by a logical examination of facts and projections.

The kilowatt-hours of electricity generated in 1974 showed no growth over the previous year. During the first half of 1975, only a 2 percent increase was experienced and it does not appear that the year-end totals will exceed a 3 percent increase. Thus, production of electricity for 1975 should be in the neighborhood of 1.91 trillion kilowatt-hours.

Yet, electric utilities added about 38,000 Mwe generating capacity in 1974 and will probably add another 25,000 Mwe generating capacity in 1975. (New installations totalled 18,000 Mwe in the first eight months of the year). The total stock of plants by the end of 1975 should be in the neighborhood of 500,000 Mwe, an increase of 100,000 Mwe in three years. The obvious reason for the continued completion of new plants despite small growth of demand was to get plants under construction included in the rate base so that a return on investment could begin.

A figure of merit used to evaluate the electric system is an end-of-year system capacity factor. This number is computed by dividing the actual kilowatt-hours produced in the year by the kilowatt-hours that could have been produced by the stock of plants existing at the end of the year if these plants had operated at full capacity for the entire year. This value understates the actual system capacity factor by 2 to 3 percentage points, but it is much simpler to calculate and conveys the same information. The historic end-of-year capacity factor seems to center around 51 percent. For 1975, this figure of merit will be around 43.6 percent.

Our projection cases in the early part of this year indicated a kilowatt-hour growth rate around a 6 percent annual average through 1985. Subsequent analysis prepared for ERDA–48, The National Energy RD&D Plan [1] reflected growth rates between 5.3 and 6.1 percent. For purposes of illustration here, the 6 percent rate is used, which is slightly higher than the 5.3 to 5.8 percent range given in a recent Edison Electric Institute report.[2] By 1980, the electricity production would be 2.55 trillion kilowatt-hours.

Our assumption is that the excess capacity existing today will be gradually worked off during the next few years as utilities hedge against the possibility of higher consumption growth. The end-of-year system capacity factor is estimated to improve only ot 48.5 percent by 1980. These estimates mean that the total installed capacity through 1980 would be around 600,000 Mwe. Thus, approximately 100,000 Mwe of new capacity would be required during the next five years which is equivalent to the additions in the last three years. Continuing a 6 percent growth in the subsequent five years and following the reduction of excess capacity, the new additions in the 1981–1985 period are anticipated to be near 175,000 Mwe.

Although the slower growth rate of new generating capacity will affect all types of powerplants, numerous factors have combined to signify major changes in nuclear power growth projections. In February 1974, the Atomic Energy Commission [3] felt that 250,000 Mwe by 1985 was a reasonable planning number. In February 1975, the estimates [4] were revised downward to a planning range of 185,000–205,000 Mwe by 1985, representing a 25 percent reduction in projected capacity. A recent limited analysis now shows that even reaching the 185,000 Mwe value is highly doubtful and that 160,000–170,000 Mwe may be a more practical planning number.

The message derived from these calculations is that the new plant construction for the next five years appears quite manageable when compared to previous performance. Even the early 1980's does not appear to present overly burdensome problems if the growth rate of electricity consumption does not greatly exceed a 6 percent value. The much reduced level of new plants greatly reduces the capital requirements problem that loomed so large a year ago.

It is true that new plants are far more costly than previously experienced so that continued pressure is exerted on the financing capabilities of the utilities. However, the financial and cash-flow positions of most utilities have improved substantially in recent months. Though much delayed, rate increases over and above fuel escalation clauses are being regularly granted by state public utility commission. Investor confidence is returning as evidenced by the regular marketing of securities and the upward rise in stock prices. The reduced construction programs caused by the lower growth is assisting the management of

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[1] U.S. Energy Research and Development Administration, *A National Plan for Energy Research, Development and Demonstration: Creating Energy Choices for the Future,* ERDA–48, June 1975.

[2] Edison Electric Institute, "Economic Growth in the Future," EEI Publication No. 75–32. June 1975.

[3] U.S. Atomic Energy Commission, "Nuclear Power Growth, 1974–2000," WASH–1139 (74), February 1974.

[4] Roger W. A. LeGassie, ERDA Testimony before the Joint Committee on Atomic Energy, June 10, 1975.

cash-flow problems. Even if inflation continues to escalate plant costs, one must recognize that rate increases will be granted to keep pace with the inflation although time lags will occur.

FINANCIAL HEALTH OF ELECTRIC UTILITIES

During the past year, the Federal government has been investigating a number of potential policy or legislative changes to improve the financial health of electric utilities. These proposals are currently being reviewed with respect to the revised electric energy projections and studies estimating the anticipated effects and responses to proposed actions. Because more than a year has elapsed since the onset of utility financial difficulties, many of the actions must now be oriented toward preventing additional unwarranted delay of new plants over the next few years rather than returning plants to original schedules.

Despite all the publicity about Federal proposals and possible actions, there have been only three basic actions adopted this year. The tax laws were changed to increase the investment tax credit, an "open-season" on enriched uranium contracts permitted a change in contractural schedules and thus payment schedules, and the Oil Entitlements Program reduced the cost of oil to utilities on the East Coast until full-cost pass-through provisions were established for those utilities.

As for the rest of the proposals, they remain just that—proposals. The Utility Act of 1975 which would shorten regulatory lag, prevent exclusion of construction work in progress from the rate base, prevent exclusion of the cost of mandated environmental controls, and require full fuel-cost adjustment on a monthly basis remains in Congressional Committee. The Electric Power Facility Construction Incentive Act of 1975 which would increase the investment tax credit to 12 percent indefinitely, extend the provision for fast write-off of pollution control facilities, and permit depreciation deductions on the construction of non-oil and non-gas facilities as expenditures are made remains in Congressional Committee. The legislation for establishing the Energy Independence Authority has only recently been submitted and rapid action is not expected.

Administrative options that have been discussed, but not yet implemented include: active Federal intervention in state rate cases for higher rates, Federal Reserve loans, and fuel lending to utilities under the provisions of the Defense Production Act. The Federal Energy Administration is still formulating national guidelines for electricity ratemaking. By the lack of action, one can see that federal assistance to utilities has been rather minimal.

The value of the adoption of these proposals now, after a full year's delay since conception must be considered in terms of two major factors. The first factor is what would be the magnitude of the monetary gain either in increased revenues or reduced costs. Many suggested proposals will provide financial gains more cosmetic than real when compared to the size of assistance needed. An excellent paper by Robert Uhler of the Federal Power Commission [5] analyze the relative effects of various policy alternatives on capitalized expenditures, external financing requirements, projected revenues, average consumer charges, and taxes. Uhler found that slowing the growth rate of capacity, delaying pollution control expenditures, and including construction work in progress in the rate base had relatively large impacts while such items as depreciation changes and dividend payout changes were much less important.

The second factor is what is the likelihood of utilities responding to financial incentives by improving their construction schedules. A study [6] performed early this year addresses this issue in analyzing the delays of nuclear power plants in 1974. That study found that 34 plants under construction and 23 plants in construction permit review were delayed for reasons that could be linked to financial problems. However, twenty-three of these plants were also linked to load growth delays at that time. Only about 25 of those 57 plants were expected to respond to incentives at that time. During 1975, many schedule slippages have also occurred but relatively few were precipitated by financial difficulties. The passage of many months that cannot be regained and the low growth of electricity production this year must lead one to conclude that few, if any, power plants would be speeded toward completion simply due to financial assistance now.

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[5] Robert G. Uhler, "An Analysis of the Electric Utility Industry's Financial Requirements," Federal Power Commission, September 1974.

[6] Richard H. Williamson, "Analysis of Nuclear Power Plant Delays in 1974," ERDA, unpublished paper, February 1975.

So, it is not entirely clear that adoption of Federal proposals will really have a great effect today. It appears that the financial health of the utilities is steadily improving, even in the almost total absence of Federal assistance. It also appears that the forces of the energy-economic system have worked to remove a large part of the capital requirements problem in little more than a year since the financial difficulties of the utilities became widely known.

[From Electrical Week, Feb. 9, 1976]

KEY TREASURY AIDE: UTILITY EARNINGS UP TOO FAST TO EXPECT MUCH TAX HELP

Assistant Treasury Secretary Sidney L. Jones said last week that electric utility earnings had "come back too fast" for utilities or investors to expect a tax break for those re-investing their dividends in utility stocks. In his State of the Union message, President Ford said he would propose legislation that would allow utility stockholders to defer paying taxes on dividends if they reinvested the dividends in the company's stock.

Jones' comment was in response to the question of a utility official at a conference in Gainesville, Fla., sponsored by the University of Florida's Public Utility Research Center. The youthful Treasury aide, and author of much of Treasury Secretary William Simon's testimony before Congress, indicated that his response was based partly on his reading of Congressional attitudes in this election year and partly on staff opinion at the Treasury Dept. As for Congress, Jones said at another point in the discussion, "I don't think calendar year 1976 is going to be one of great initiative."

He said that much of the concern that the Administration and Congress had last year for financially strapped utilities "has been dissipated" by the "generally improved financial showing" of the industry. Asked later if the Administration would push President Ford's six-point, $600-million tax-relief plant for utilities (EWk, 12 Jan. 1), Jones said only: "That remains a part of the program." But he had expressed his view earlier that utilities "would be better off with long-range federal policies that would encourage capital investment than with stop-gap tax incentives such as an increase in the investment tax credit."

Jones said utility men should look upon the proposed increase (to 12% from the present 10%) of investment tax credit as a temporary measure at best: "It has been off and on three times since World War II." Further, he said; "One of these days some academic—and maybe it will be me—is going to carve up the whole investment-tax-credit thing as a special-interest loophole just like the oil-depletion allowance."

The Assistant Treasury Secretary's remarks on utility tax matters came during the discussion period following his talk on the need to encourage capital formation in the United States. In his presentation he made no specific reference to utility matters. Jones spoke before some 50–65 utility and regulatory officials, most of them from Florida but several from such states as Texas, North Carolina and New York.

[From Weekly Energy Report, Feb. 9, 1976]

THIS WEEK IN ENERGY FINANCING

UTILITY STOCK MARKET HAS THE BULL BY THE HORNS

(By Jerry Edgerton)

The bicentennial bull market that has kicked off 1976 has included healthy gains for most electric utility stocks. And most Wall Street analysts and underwriters who follow the industry believe that these increases, although benefiting from overall market strength, also reflect stronger utility finances that should lead to improved performance even beyond the current surge. One result of the higher common stock prices will likely be heavier sales of utility equity, especially early in the year. This also may mean greater financing flexibility if a need is seen to restore some construction cutbacks later in 1976.

"After weathering a plethora of problems caused by high inflation, the industry is regaining some of its financial viability and part of its former investment image," says analyst John Ledda of Shields Model Roland in a just-published

research report. Ledda notes that electric utility stock prices have gained some 20 percent since mid-September, with nearly half that gain coming in January.

Ledda and others point out that record-high rate increases granted in 1975, earnings that were up some 10 percent over 1974, and some recent dividend increases all serve to make electric utility stocks seem more investment-worthy than they have in two years. Average actual return on equity moved up to around 11 percent in 1975—a gain from the 10.7 percent of 1974 but still well below the 12.5–13 percent often achieved in the mid-1960s.

As prices rise, many utility stocks that have long languished below book value are approaching or have gone above the book figure.

"As they get a smell of book value, we're going to see an acceleration of common stock financing," says Carl Seligson, a vice president of Merrill Lynch, Pierce, Fenner & Smith who specializes in utility underwriting. Merrill Lynch is projecting a possible total of $1.5 billion utility equity sold in the first quarter alone. Numerous utilities which had planned to sell equity later in the year will likely speed up their schedule to take advantage of the higher prices. And some companies that already had scheduled equity sales have increased the number of shares.

Seligson was predicting last fall that the utility common stock total for 1976 would be in the $3.5 billion range. But now he says that the higher prices and potentially higher volume could result in a total closer to $4 billion.

This pattern, as did the record 1975 equity totals, improves utilities ratio of equity to debt, helping to protect or enhance bond ratings. Improved earnings help increase coverage of fixed interest charges. Thus by later this year, many utilities should have considerably improved financing flexibility if it appears that parts of their cancelled or deferred construction programs might be restored. "Those high reserve margins could be whittled away faster than some people have been expecting," predicts Ledda.

A key factor here, of course, will be the growth in industrial sales of electricity which lagged all last year while residential and commercial sales were gaining. Several companies recently have reported industrial sales back at prerecession levels, and if economic recovery continues this trend, it should further help utility earnings.

Wall Street specialists also believe that a better climate has developed in many states for granting reasonable rate increases. They feel if this trend coninues and inflation can be held in check, utility earnings should continue to look brighter. "Utilities have to make it either on sales or rates," said Norman Greenberg, vice president for research at Drexel Burnham & Co. "The rates have been falling into place in a reasonable fashion. And now we're starting to see some improved sales."

Also viewed as a positive development is the tendency at some commissions to allow moving away from non-cash income items and the resulting improvement in quality of earnings. As Ledda notes, "Another trend is for gradual phase-out of the (non-cash) allowance for funds used during construction (AFDC) in favor of including at least part of the construction work in progress (CWIP) in the rate base."

CON ED INDICATIVE

Indicative of the market trend is the performance of Consolidated Edison of New York, the company whose 1974 dividend omission had so much to do with the industry's financial problems of that year. In mid-November Con Ed stock stood at $12.13 per share, and by last week it had risen to $17.50. The company announced that for the first quarter it is raising its dividend to 40 cents a share—almost back to the 45 cents it was paying before the 1974 problems, and 10 cents above the 30 cents it paid in 1975. Con Ed earnings for 1975, after extraordinary charges, were $3.36 per common share compared with $2.44 in 1974.

Looking ahead, most analysts feel it is possible that electric utility stocks could register further gains, but specific performance depends at least in part on the general economic picture. As always, there stocks are sensitive to interest rates, and a significant rise in short-term rates could slow down potential increases. Just how strong this effect would be is something of an issue.

More pessimistic prognosticators believe an interest rate rise could effectively end the rally for the electric utility stocks. Representative of a more positive school of thought was an analyst for a major bank, who said: "I don't think it's that simple. Interest rates are only one of the factors. We could be seeing the beginning of a complete reversal of a 10-year downtrend for these stocks."

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